Answers

1 David Sole

(a) **Taxable income for the year of assessment ended 29 February 2008**

	R
Orgshops – taxable income	600,000
Prorents, residential flats – loss	(18,000)
Taxable income	582,000
Assessed losses – carried forward	
Holiday apartment trade 1,000 + 2,000	3,000
Farmprops 70,000 + 100,000	170,000

(b) **Report to:** **David Sole**
Prepared by: **Tax advisor**
Date: **2 June 2008**
Subject: **The ring fencing of losses and associated matters**

(i) **Assessed losses**
An assessed loss will be created where expenditure and allowances in terms of the Income Tax Act, ss.11 to 19, are greater than the income as defined. Income is gross income minus exemptions. Certain allowances and deductions may not give rise to an assessed loss or increase an assessed loss. An example would be the debtors allowance or the retirement annuity deduction.

Assessed losses include balances of assessed losses brought forward from previous years, if any.

(ii) **Ring fencing – general principles**
Ring fencing of losses can only occur if taxable income, without taking the losses into account, equals or exceeds the amount at which the maximum marginal rate of tax becomes applicable.

You will have taxable income of R600,000 from Orgshops and will have tax charged at the maximum rate of 40% on amounts over R450,000. Therefore you are potentially at risk for the ring-fencing of assessed losses from your loss-making trades.

(iii) **Ring fencing – rental losses**
The first issue to be determined here is whether the rental of the holiday apartment and the rental from the residential flats can be viewed as one trade.

It appears that these are two very different trades in that they have different investment purposes. The holiday apartment is let mainly to family members and the residential flats on longer lets on a more commercial basis.

As the holiday apartment is let for more than 80% of the time to family members, this will be regarded as a suspect trade. The loss will be ring-fenced immediately.

The residential flats are not suspect trades but losses have been made in the last three years which means that this trade could be ring-fenced in terms of the three out of five year rule.

The only way to defend an attack by CSARS on this basis is to prove that the letting of the residential flats is a business in respect of which there is a reasonable prospect of deriving taxable income (other than a taxable capital gain) within a reasonable period having special regard to the way in which the business has been conducted.

Some of the factors CSARS will consider are:
– the proportion of gross income to allowable expenditure;
– the level of activities;
– whether the trade is carried on in a commercial manner;
– the number of years trading and losses made since commencement of the trade and any unexpected circumstances;
– the business' plans; and
– the extent of private use in the case of a business asset.

(iv) **Ring fencing – farming losses**
A farming activity carried out on a part time basis is regarded as a suspect trade. This means that the 'losses made in three out of five years' rule does not apply.

Only if you can prove that you carry on farming on a full time basis (most of your normal working hours) will it not be classified as a suspect trade, and the three out of five years losses rule would then apply.

Whether it is considered a suspect trade or falls under the three out of five years losses rule, you may yet avoid ring-fencing as discussed above if you can prove that the farming trade has a reasonable prospect of deriving income within a reasonable period.

(v) Use of a close corporation

The ring fencing of losses only applies to natural persons. If all the trades were operated in a close corporation all losses would be set off against any available taxable income and only one aggregate taxable income or assessed loss would be derived. The taxable income would be taxed at 29%.

However, if such a strategy were to be adopted, there is a danger of falling foul of the general anti-avoidance rules (GAAR) in s.80 of the Income Tax Act, as you will have transferred the trades to the close corporation in order to obtain a tax benefit.

2 (a) Lategan (Pty) Limited (Lategan)

Section 31 of the Income Tax Act deals with international agreements – thin capitalisation and transfer pricing.

One of the determinants of an international agreement is whether a transaction, operation or scheme entered into between a resident and any other person who is not a resident is in place. Lategan, a resident, has entered into an operation – the loan agreement – with a non-resident shareholder.

A further requirement for the section to operate is that the parties to the transaction are connected persons. The non-resident shareholder holds 20% of the equity shares of Lategan which qualifies him as a connected person as he holds at least 20% of the company's equity share capital.

It must then be determined if the financial assistance granted to Lategan is excessive in relation to the fixed capital (share capital and accumulated profits).

The Commissioner for the South African Revenue Services (CSARS) will allow borrowings of up to three times the total shareholders' investment.

The fixed capital is	R300,000
Loans permitted 300%	R900,000
Non-resident holds 20%	R180,000
The maximum loan permitted is	R180,000

The difference of R120,000 is therefore regarded as excessive and the interest of R10,800 (R120,000 x 9%) will be disallowed as a deduction in order to arrive at taxable income.

In addition to thin capitalisation, the interest charged on the allowable loan limit could be regarded as excessive if it exceeded the prime bank rate plus 2%. This is not the case here.

Secondary tax on companies (STC) of R1,080 (10,800 at 10%) will be chargeable on the disallowed interest.

(b) Lynn Carter

Tax Manager
ABC Certified Accountants
Firm's address

Mrs Lynn Carter
Address
Date

Dear Mrs Carter

In reply to your queries regarding your investment in Pluto Plc I wish to advise as follows:

(i) In order to decide whether to claim a deduction for withholding tax, it is necessary to compare your taxable situation with the deduction and without the deduction.

If a s.11(a) deduction is made, then the effect will be as follows:

	R
Dividend from Pluto 114,750/90%	127,500
Foreign dividend exemption	(3,000)
	124,500
Section 11(a) (127,500 – 114,750)	(12,750)
Income taxable at 40%	111,750
Tax payable at 40%	44,700

No credit for foreign taxes will be given

(ii) Alternatively, you could elect for Pluto Plc to be deemed a controlled foreign company (CFC) in which case the tax payable will be calculated as follows:

	R
Net income – Pluto (990,000 x 15%)	148,500
Dividend – gross income	127,500
Dividend – exempt (net income included)	(127,500)
Section 11(a) not applicable as no inclusion	–
Income taxable at 40%	148,500
Tax payable at 40%	59,400
Section 6*quat* credit 15% x (150,000 x 990/1,000)	(22,275)
Net tax payable	37,125

Thus, if you elect to treat Pluto Plc as a CFC you will only pay tax of R37,125 as opposed to R44,700 if you do not make this election. This is therefore the better option.

(iii) However, if Pluto Plc was not elected to be a CFC and no s.11(a) deduction was made then the withholding tax will be allowed as a credit against the tax payable, as follows:

	R
Dividend after exemption	124,500
Tax payable at 40%	49,800
Less section 6*quat* (127,500 x 10%)	(12,750)
Net tax payable	37,050

This is the best option of the three available, and the one we would advise you to adopt.

Please do no hesitate to contact us again, should you require any clarification of the above, or further advice.

Yours sincerely,

Tax Manager
ABC Certified Accountants

(c) Classic Design (Pty) Ltd

(i) The fact that the amounts are not material for financial reporting purposes does not cover the income tax situation. The legislation determines whether a deduction is permitted for repairs and maintenance.

Section 11(d) allows a deduction for expenditure actually incurred during the year of assessment on repairs to property occupied for the purpose of trade.

If the expenditure incurred is an improvement no deduction is permitted in terms of s.11(d). Improvements are extensions, additions or improvements (other than repairs to a building).

No regard should be had to the quantum of the expense.

The principle laid down by case law is that if the intention is to improve or that repairs are made beyond the original condition so as to have a better or different asset than the original, then it is an improvement and no deduction will be allowed.

The amount incurred for the improvement must be added back to income on the tax return.

(ii) I would have a duty to inform the Commissioner for the South African Revenue Services (CSARS) and should notify the company that I am obliged to do so if they do not rectify the matter.

3 Dennis Qually

(a) (i) The donation of the interest bearing securities and shares to the trust would have given rise to donations tax.

Donations tax would have been calculated on the market value of the assets (R5m) at 20%. An exemption of R100,000 would have been allowed if Dennis had made no other previous donations in that tax year. Thus the minimum tax due would be R980,000 (20% x (R5m – 100,000)).

Capital gains tax would also have been payable on the market value of the assets less their base cost.

A portion of the donations tax paid would have been added to the base cost.

The calculation would have been:

Proceeds less base cost and donations tax attributed
Less R15,000 annual exclusion
Capital gain x 25% included in taxable income

(ii) Dennis could have avoided the charge to donations tax by selling the assets to the trust, as opposed to gifting them. Even though the trust does not have the cash to pay for the assets, this can still be done by means of an interest-free loan account.

(b) The retained income in the trust will be taxed in the hands of Dennis as the income has arisen because of his donation. The income would retain its nature and be in the form of interest and dividends as follows:

	R
Interest 40,000 x $^{70}/_{180}$	15,556
Dividends 40,000 x $^{110}/_{180}$	24,444
Dennis would be entitled to the following exemptions (if not used already)	
Interest exemption R18,000 limited to	(15,556)
Dividend exemption	(24,444)
Taxable income	Nil

(c) Jason's distribution of R15,000 will be taxed in the hands of Dennis as Dennis has made a donation and as a result thereof a non-resident has received income (s.7(8)).

It will retain its nature as interest and dividends as follows:

Interest 15,000 x $^{70}/_{180}$	R5,833
Dividends 15,000 x $^{110}/_{180}$	R9,167

(d) **Dennis Qually – Taxable income for the year of assessment ended 29 February 2008**

Retained income (see (b))	Nil
Jason interest (see (c))	5,833
Interest exemption (18,000 – 15,556)	(2,444)
Dividends R9 167 – exempt	–
Sarah minor child	
Interest 25,000 x $^{70}/_{180}$	9,722
Dividends 25,000 x $^{110}/_{180}$ – exempt	–
	13,111

4 Astec Limited

(a) **The tax implications of the write off of the debt owing for Astec Limited**

Trade debt
The R10,000 will be included in gross income as a recoupment as it is an amount which is never paid – s.8(4)m.

There would be a VAT adjustment in respect of the input VAT claimed on the purchase being an output of R1,228 (10,000 x $^{14}/_{114}$). This is because it has not been paid within 12 months.

Loan and interest
The loan was never allowed as a deduction therefore there can be no recoupment under s.8(4)m.

The unpaid loan debt of R30,000 which has prescribed or been waived, will be subject to capital gains tax – paragraph 12(5) of the Eighth Schedule.

The interest on the loan of R3,000 will be a recoupment in terms of s.8(4)m as the interest incurred would have been allowed as a deduction under s.11(a) in previous years.

(b) **The tax implications of the transactions in spare parts for Astec Limited**

The spare parts sold other than in the course of trade would be included in gross income in terms of s.22(8) at their market value of R15,000.

There would be a deemed VAT output on the greater of the market value and the consideration, as the supply is to a non-vendor, of R1,842 (15,000 x $^{14}/_{114}$).

The spare parts purchased for R5,000 would be allowed as a deduction after reducing the amount by the deemed input VAT claimable.

The VAT would be R491 (4,000 x $^{14}/_{114}$) – deemed input on second hand goods, and the deduction therefore R4,509 (5,000 – 491).

(c) **The income tax implications of the transactions in spare parts for the holding company**

A deduction of R12,000 would be allowed if the cars are used in the production of income – s.11(d).

If the spare parts are still on hand at the end of the year this amount would be included in the value of the closing stock.

The sale of parts to Astec would be included in gross income at the market value of R4,000.

(d) The tax implications of the lease for Astec Limited

Lease payments would be deductible (net of VAT)		
Lease payment	3,483	
Less VAT 14,000/36	(389)	(3,094)
A recoupment would be included in gross income of the market value less any consideration (40,000 – 30,000)		10,000
A s.11(e) allowance would be granted on the market value of the vehicle from 1 May 2008 (40,000 x 25% x $^{2}/_{12}$)		(1,667)

No input VAT would be payable as this was claimed in full at the beginning of the lease.

5 John Mcguire

(a) Annual taxable income

Employment			R
Salary	25,000 x 12		300,000
Use of motor car	340,000 x 2·5% x 12		102,000
Medical contributions	2,000 x 12	24,000	
Less allowable	(530 + 530) x 12	(12,720)	11,280
			413,280
Partnership			
Share of profit	600,000 x 20%		120,000
Salary	15,000 x 12		180,000
Use of motor car	not an employee		–
Medical contributions	not an employee		–
	paid on behalf of John 2,000 x 12		24,000
			324,000

(b) Cash flow effect

Employment			
Income			300,000
Tax payable on R413,280		117,171	
Less rebate		(7,740)	(109,431)
Net inflow			190,569
Partnership			
Income	120,000 + 180,000		300,000
Tax payable on R324,000		84,025	
Less rebate		(7,740)	(76,285)
Net inflow			223,715

Conclusion
The partnership offer is the better option for John as, although the cash income is the same, the tax payable is R33,146 higher under the employment package.

(c) Disadvantages to John

– He will have to become a provisional tax payer.
– He could also be liable for employee's tax on the salary he earns.
– He is jointly and severally liable with the other partners for the debts of the partnership.
– The partnership could incur losses in the future and this would directly affect his income as a partner.

(d) Sale of depreciable capital asset

The sale of a depreciable capital asset for more than its cost would give rise to both a recoupment and capital gains tax.
The recoupment would be included in the income of the partnership and shared by the partners (in their profit sharing ratio) through their share of the net profit.
The capital gain would be calculated after taking the full recoupment and any capital allowances into account.
The resulting gain would be split between the partners in their profit sharing ratio of 40 : 40 : 20.
Each partner would then be able to set off their portion of the gain against any available capital losses.
Each partner would be entitled to the R15,000 exclusion against their aggregate gains and losses.
The resulting gain would be included in their taxable income at 25%.

			Marks
1	David Sole		
(a)		Offset of Prorents loss	1
		Assessed losses carried forward (2 x 1)	2
			3
(b)	**(i)**	Definition of assessed loss	1
		Unavailability of certain allowances to create/increase a loss	$^1/_2$
		Includes brought forward balances	$^1/_2$
			2
	(ii)	General principle re ringfencing of losses	1
		Application to David	1
			2
	(iii)	Identify one trade or two issue	1
		Conclude two trades with reason	2
		Identification of holiday apartment as a suspect trade with reason	1
		Identification of residential flats as a non-suspect trade with reason	1
		Basis on which David can defend CSARS attack	2
		Factors CSARS will consider ($^1/_2$ mark each) – maximum	2
			9
	(iv)	Identify part-time farming activity as a suspect trade	1
		Consider position of a full-time farming activity	1
		Consider 'reasonable prospect of deriving income' issue	1
			3
	(v)	Ring-fencing of losses only applies to natural persons	1
		Aggregation of income/losses in a close corporation	1
		Consider application of GAAR	2
			4
		Format and presentation of the report	1
		Effectiveness of communication	1
			2
			25

		Marks
2	**(a) Lategan (Pty) Limited**	
	Thin capitalisation:	
	Transaction between a resident and a non-resident	1
	Application to Lategan	1
	Parties connected persons	1
	Application to Lategan	1
	Financial assistance excessive	1
	Determination of maximum loan	2
	Calculation of disallowed interest	1
	Consideration of interest rate/transfer pricing	1
	Determination of secondary tax chargeable	1
		10
	(b) Lynn Carter	
	(i) Computation of tax payable if s.11(a) deduction made	2
	No credit given for foreign taxes	1
		3
	(ii) Computation of gross tax payable if elect Pluto as deemed CFC	3
	Offset of s6quat credit	2
	Conclusion re better option	1
		6
	(iii) Identification of withholding tax credit as third alternative	1
	Computation of net tax payable	2
	Overall conclusion/recommendation	1
		4
	Format and presentation of the letter	1
	Effectiveness of communication	1
		2
	(c) Classic Design (Pty) Ltd	
	(i) Legislation determinant for tax purposes	1
	Section 11(d) general requirements for a deduction	1
	Improvements *prima facie* disallowed	1
	Quantum not relevant	1
	Appropriate references to principles established in case law (3 x 1)	3
	Application/conclusion re specific case	1
		8
	(ii) Duty to inform CSARS	1
	Duty to notify company accordingly	1
		2
		35

			Marks
3	**Dennis Qually**		
(a)	**(i)**	Identify liability to donations tax	1
		Calculate minimum donations tax payable	2
		Identify liability to capital gains tax	1
		Identify availability of relief for donation tax paid	1
		Describe basis for calculation of CGT	1
			6
	(ii)	Ability to mitigate donations tax if use sale rather than gift	1
		Identify use of interest free loan to facilitate this	1
			2
(b)	Explanation of basis of taxation		2
	Calculation of attributable income (2 x $^1/_2$)		1
	Applicable exemptions (2 x 1)		2
			5
(c)	Explanation of basis of taxation		2
	Identification of taxable amounts (2 x $^1/_2$)		1
			3
(d)	Retained income (ex part (b))		$^1/_2$
	Jason:		
	Interest (ex part (c))		$^1/_2$
	Interest exemption		1
	Dividends exempt		$^1/_2$
	Sarah:		
	Interest		1
	Dividends exempt		$^1/_2$
			4
			20

		Marks
4	**Astec Limited**	
(a)	Recoupment re trade debt	1
	Loan:	
	No recoupment	1
	Capital gains tax charge	1
	Recoupment re interest	1
	VAT position	2
		6
(b)	Parts sold:	
	Inclusion in gross income at market value	1
	Output VAT	1
	Parts purchased:	
	Deductible amount	$1^1/_2$
	Deemed VAT input	$1^1/_2$
		5
(c)	Parts purchased:	
	Deduction	1
	Closing stock	1
	Parts sold	1
		3
(d)	Deductible lease payments	2
	Recoupment	2
	Section 11(e) allowance	1
	VAT position	1
		6
		20

		Marks
5	**John Mcguire**	
(a)	Employment:	
	Salary	$^1/_2$
	Use of car	1
	Medical contributions	2
	Partnership:	
	Share of profit	$^1/_2$
	Salary	$^1/_2$
	Use of car	1
	Medical contributions	$1^1/_2$
		7
(b)	Employment:	
	Correct taxable income	1
	Tax payable net of rebate	1
	Partnership:	
	Correct taxable income	1
	Tax payable net of rebate	1
	Conclusion	1
		5
(c)	1 mark for each valid disadvantage – maximum	3
(d)	Recoupment	$1^1/_2$
	Capital gain:	
	Basis of calculation	$1^1/_2$
	Basis of allocation to partners	$^1/_2$
	Treatment in the hands of the individual partners:	
	– offset of losses	$^1/_2$
	– annual exclusion	$^1/_2$
	– 25% scaling	$^1/_2$
		5
		20