Professional Level – Options Module

Advanced Taxation (South Africa)

Monday 2 June 2008

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

ACCA

SUPPLEMENTARY INSTRUCTIONS

1. Calculations and workings need only be made to the nearest R.
2. All apportionments should be made to the nearest month.
3. 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 29 February 2008
Rebates	
Primary rebate	R7,740
Secondary rebate (over 65)	R4,680
Interest exemption	
Under 65	R18,000
Over 65	R26,000
Companies	
Normal tax rate	29%
STC rate	10%

Schedule 1
Rates of normal tax payable by persons (other than companies)
in respect of the year of assessment ended 29 February 2008

Taxable income	Rates of tax
Up to R112,500	18% of each R1 of the taxable income
exceeds R112,501 but does not exceed R180,000	R20,250 plus 25% of the amount over R112,500
exceeds R180,001 but does not exceed R250,000	R37,125 plus 30% of the amount over R180,000
exceeds R250,001 but does not exceed R350,000	R58,125 plus 35% of the amount over R250,000
exceeds R350,001 but does not exceed R450,000	R93,125 plus 38% of the amount over R350,000
exceeds R450,001	R131,125 plus 40% of the amount over R450,000

Tax rates for small business corporations for the
year of assessment ended 29 February 2008

Taxable income	Rates of tax
Up to R43,000	Nil
R43,001 to R300,000	10% of the amount over R43,000
R300,001 and above	R25,700 plus 29% of the amount over R300,000

Rating formula

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

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

Travel allowance table
For years of assessment commencing on or after 1 March 2006

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
Up to 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

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

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Question 1 begins on page 5.

Section A – BOTH questions are compulsory and MUST be attempted

1 David Sole has conducted various trading activities in South Africa for some years. The results of these activities for the year of assessment ended 29 February 2008 are as follows:

David Sole trading as	Prorents	Farmprops	Orgshops
	R	R	R
Taxable trading profit/loss	(20,000)	(100,000)	600,000

Prorents
This business rents out properties, consisting of a holiday apartment and two residential flats. The holiday apartment is situated on the coast and the two flats are in the same block in the city.

The trading losses incurred on these rental properties have been as follows:

	Holiday apartment	Residential flats
	R	R
2006	(3,000)	(8,000)
2007	(1,000)	(4,000)
2008	(2,000)	(18,000)

The holiday apartment is let to family members for at least 85% of the time on a continual basis. The flats are both let to third parties who are not relatives of David.

Farmprops
David has been running a farm on a part time basis. David grows olive trees and intends to harvest the olives for making soap and olive oil. The trees are still growing and have not produced any fruit as yet. He commenced with this trade in 2007 and made an assessed loss of R70 000 in that year.

Orgshops
David has a chain of four shops selling organic products. They are situated in shopping malls spread around the Western Cape. The shops are all profitable and there have been no losses in the previous three years.

David is concerned that his losses will not be allowed for set-off against his profits in 2008 and future years. In addition he would like advice as to how he could better structure his trades in order to take maximum advantage of any losses he makes.

Required:

(a) Calculate David Sole's taxable income for the year of assessment ended 29 February 2008 if the holiday apartment trade and the farming trade were ring-fenced from the 2007 year of assessment. State what amounts will be carried forward. (3 marks)

(b) Prepare a report for David Sole in your capacity as his tax advisor, in respect of the following matters:

(i) How assessed losses are created in terms of the Income Tax Act. (2 marks)

(ii) Whether, on an overall basis, David is potentially at risk for the ring-fencing of his losses in the year of assessment ended 29 February 2008. (2 marks)

(iii) Whether the rental losses can be ring-fenced and if there are any factors which would assist David in defending an intention by the Commissioner of the South African Revenue Services (CSARS) to ring-fence any part of these losses. (9 marks)

(iv) Whether the loss made by the Farmprops trade can be ring-fenced. (3 marks)

(v) The basis on which David's income and losses would be taxed if he formed a close corporation and operated all his trades in the close corporation, and whether there is any risk associated with amalgamating all his trades in a close corporation. (4 marks)

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

(25 marks)

2 You are employed by a firm of chartered accountants as a manager in its taxation division. You are required to provide answers to queries (including those relating to offshore transactions) from three separate clients.

The queries that you must deal with are as follows:

(a) Lategan (Pty) Limited (Lategan)

Lategan has a financial year end on the last day of February. It is paying interest at 11% on a bank overdraft of R300,000. The overdraft arose as a result of working capital requirements. Lategan's equity shares and voting rights are held to the extent of 80% by residents and 20% by a non-resident.

The non-resident is prepared to lend Lategan R300,000 at 9%. This R300,000 would then be used by Lategan to repay its bank overdraft. The equity and liability portion of Lategan's balance sheet would then be as follows:

	R
Share capital (100,000 shares at R1 each)	100,000
Revenue profits	200,000
	300,000
Loan from non-resident shareholder	300,000
	600,000

Lategan has never held shares in any other company.

Required:

Analyse the scenario and determine all the normal tax and the secondary tax on companies (STC) consequences that will arise if Lategan (Pty) Limited enters into the proposed loan agreement with its non-resident shareholder assuming that, if the transaction took place, it would have occurred on 1 March 2007. (10 marks)

(b) Lynn Carter

Pluto Plc (Pluto) is not a resident of the Republic and none of its receipts or accruals are from a South African source. Pluto's shares are held by Lynn Carter to the extent of 15%, and by non-residents to the extent of 85%. Pluto is not a business establishment.

For its current foreign tax year (which ended on 31 December 2007), Pluto made a taxable profit of the equivalent of R1,000,000. The corporate tax charged on the taxable profit amounted to the equivalent of R150,000. The company's entire after tax income was then distributed as a dividend. Lynn Carter received a net dividend of R114,750 from this distribution. Withholding tax of 10% was deducted at source.

If Pluto had been a controlled foreign company (CFC) then its net income for its foreign tax year (ended on 31 December 2007) as determined under the provisions of section 9D(2A) would have been the equivalent of R990,000.

Lynn Carter pays normal tax in South Africa at the maximum marginal rate of 40%. She has not yet enjoyed the exemption of the first R3,000 of not otherwise exempt foreign dividends.

Required:

Write a letter to Lynn Carter advising her on the following, giving supporting calculations where appropriate:

(i) Whether she should deduct her withholding tax in terms of s.11(a), assuming no CFC election is made. (3 marks)

(ii) Whether she should elect that Pluto Plc be deemed to be a CFC, assuming no deduction is claimed for the withholding tax in terms of s.11(a). (6 marks)

(iii) Whether there is any other option which would be more beneficial. (4 marks)

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

(c) Classic Design (Pty) Ltd (Classic)

Classic is a company specialising in the retailing of designer footwear. During the 2008 year of assessment certain repairs and improvements to the company's show room were undertaken. Heavy rains in the area had led to extensive water seepage which caused damage to flooring and paintwork. Extensive work was required to repair the damage. Classic had been considering improving their display window and decided that this was an ideal opportunity to carry out the improvements at the same time as the repairs.

The improvement has expanded capacity as the floor area has been increased. The financial accountant of Classic has grouped all the expenditure for both the repairs and the improvements under repairs and maintenance as he feels that the improvement was only incidental to the reparations. He also considers the amount to be not material for financial reporting purposes.

Required:

(i) Explain whether you consider any adjustments to be necessary as a consequence of the above when completing Classic Design (Pty) Ltd's annual tax return. Justify your answer. (8 marks)

(ii) Assuming you do consider an adjustment to be necessary but the company has refused to do this, state briefly if you would have any further obligation(s). (2 marks)

(35 marks)

Section B – TWO questions ONLY to be attempted

3 Dennis Qually is a reasonably wealthy man and has transferred certain of his assets into a discretionary trust for the benefit of his wife, Julia and their two children, Jason and Sarah. Sarah is a minor and lives in South Africa with her parents. Jason is a major and has settled out of the country in the Netherlands as a non-resident. The trustees of the trust are Dennis and his brother, David, and their legal advisor.

In 2006 Dennis donated interest bearing bonds to the trust which amounted to R1 million at the time. He also donated shares, listed on the Johannesburg Stock Exchange (JSE) in South Africa, valued at R4 million to the trust in 2006.

The trust deed stipulates the following:

Julia is to receive an annual amount of R100,000 at the end of each year.

Jason and Sarah are to receive lumpsum amounts as and when the trustees decide they have a need therefor.

For the year of assessment ended 29 February 2008, the trust's income and distributions were as follows:

	R
Income	
Interest	70,000
Dividends	110,000
Distributions	
Julia	(100,000)
Jason	(15,000)
Sarah	(25,000)
Retained in the trust	40,000

Required:

(a) (i) Identify and determine all the tax implications of the donations made by Dennis Qually to the trust in 2006. (6 marks)

(ii) State how Dennis Qually could have mitigated any of the tax liabilities determined in (i), above, assuming the trust did not have cash to pay for the assets acquired. (2 marks)

(b) Explain how the retained income in the trust will be taxed and in whose hands. Support your explanations with appropriate calculations. (5 marks)

(c) Explain how Jason's distribution of R15,000 will be taxed. (3 marks)

(d) Prepare a taxable income calculation for Dennis Qually for the year of assessment ended 29 February 2008. (4 marks)

(20 marks)

4 Astec Limited (Astec) is a company which supplies spare parts to the motor industry. In its financial year ended 30 June 2008 the following occurred:

(i) An amount that was owing to a creditor was written back in the financial statements as the creditor had indicated that they no longer required payment. The amount owing had arisen in 2003 and, because the creditor had received other benefits from Astec, it had allowed the debt to prescribe.

The amount consisted of

– a loan of R30,000;
– interest on the loan of R3,000; and
– a trade debt of R10,000 for spare parts acquired as trading stock.

(ii) On 1 January 2008 Astec sold certain spare parts in stock to its holding company, which is not a value added tax (VAT) vendor, for R12,000 for use in the cars of the management. The market value of the spare parts was R15,000 and they had been included in Astec's opening stock at a valuation of R8,000.

At the same time older spare parts kept for the repair of management's cars by the holding company were sold back to Astec for R5,000. Their market value was R4,000.

(iii) Astec had been leasing a delivery vehicle at R3,483 per month. The input VAT claimed at the inception of the lease was R14,000. The thirty six (36) month lease came to an end on 1 May 2008 when the market value of the delivery vehicle was R40,000. The lease agreement stipulated that Astec would take ownership of the vehicle at the end of the lease for R30,000. Astec duly complied with the agreement on 1 May 2008.

Required:

(a) Identify and explain all the income tax and value added tax (VAT) effects for Astec Limited of the writing off of the amount owing to the creditor in (i), above. (6 marks)

(b) Identify and compute all the income tax and VAT effects for Astec Limited of the spare parts sold and purchased in (ii), above. (5 marks)

(c) Identify and explain all the income tax effects for the holding company in respect of the transactions in spare parts in (ii), above. (3 marks)

(d) Identify and compute all the income tax and VAT effects for Astec Limited for the year of assessment ended 30 June 2008 in respect of the lease in (iii), above. (6 marks)

(20 marks)

5 John Mcguire is considering a job offer from Chocolate Distributors. Chocolate Distributors is a partnership consisting of two partners James and Warren.

John has been offered the choice of an employment package or to join James and Warren as a junior partner. The two offers are as follows:

Employment package

A salary of R25,000 per month.

The use of a partnership owned motor car with a cost of R340,000 (VAT exclusive). The partnership will pay all the expenses relating to the car which are estimated at R900 per month.

The partnership will pay John's monthly contribution to a medical aid fund of R2,000 per month. John and his wife are the only members of the fund and they have no other medical expenses.

Partnership share

The partners will share profits and losses as follows:

James	40%
Warren	40%
John	20%

John would have the same use of the partnership's motor car as above.

The partnership will pay R2,000 per month for each of the partners into their medical aid funds.

Monthly salaries paid by the partnership will be:

James	R20,000
Warren	R20,000
John	R15,000

The net profit of the partnership after taking all the above into account is expected to be R600,000 per year.

Required:

(a) Calculate John Mcguire's annual taxable income from the employment package and from the partnership arrangement. (7 marks)

(b) Consider and determine from a cash flow perspective, which offer is the better option for John Mcguire. (5 marks)

(c) Briefly state the disadvantages for John Mcguire of becoming a partner. (3 marks)

(d) Explain how the sale of a depreciable capital asset for more than its original cost, by the partnership, would be treated for tax purposes, clearly stating who would be taxed. (5 marks)

(20 marks)

End of Question Paper