Professional Level – Options Module

Advanced Taxation (South Africa)

Monday 6 December 2010

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 2–4

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

Paper P6 (ZAF)

SUPPLEMENTARY INSTRUCTIONS

1. You should assume that the tax rates and allowances for the tax year 2010 will apply for the foreseeable future unless you are instructed otherwise.
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 2010/31 March 2010

Rebates	
Primary rebate	R9,756
Secondary rebate (over 65)	R5,400
Interest exemption	
Under 65	R21,000
Over 65	R30,000
Medical contribution rates	
Single member	R625
Member plus one dependant	R1,250
Each subsequent dependant	R380
Companies	
Normal tax rate	28%
STC rate	10%
Trusts (other than a special trust)	40%
Donations tax	20%
Estate duty	20%
Official interest rate (assumed)	12%

Rates of normal tax payable by persons (other than companies) in respect of the year of assessment ended 28 February 2010

Where the taxable income	
does not exceed R132,000	18% of each R1 of the taxable income
exceeds R132,000 but does not exceed R210,000	R23,760 plus 25% of the amount over R132,000
exceeds R210,000 but does not exceed R290,000	R43,260 plus 30% of the amount over R210,000
exceeds R290,000 but does not exceed R410,000	R67,260 plus 35% of the amount over R290,000
exceeds R410,000 but does not exceed R525,000	R109,260 plus 38% of the amount over R410,000
exceeds R525,000	R152,960 plus 40% of the amount over R525,000

Tax rates for small business corporations for the year of assessment ending 31 March 2010

R0 – R54,200	Nil
R54,201 – R300,000	10% of the amount over R54,200
R300,001 and above	R24,580 plus 28% of the amount over R300,000

Turnover tax rates for micro business corporations for the year of assessment ended 28 February 2010

R0 – R100,000	Nil
R100,001 – R300,000	1% of the amount over R100,000
R300,001 – R500,000	R2,000 plus 3% of the amount over R300,000
R500,001 – R750,000	R8,000 plus 5% of the amount over R500,000
R750,001 – R1,000,000	R20,500 plus 7% of the amount over R750,000

Capital gains tax

Annual exclusion R17,500

Primary residence exclusion R1,500,000

(where proceeds are R2 million or less, the full gain is excluded for the portion of the property used for domestic purposes as a primary residence)

Inclusion rate (natural persons) 25%

Inclusion rate (non-natural persons) 50%

Time apportionment formula: $Y = B + \left[\frac{(P - B) \times N}{(T + N)}\right]$

Travel allowance table for years of assessment commencing on or after 1 March 2008

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	14,672	58·6	21·7
40,001 – 80,000	29,106	58·6	21·7
80,001 – 120,000	39,928	62·5	24·2
120,001 – 160,000	50,749	68·6	28·0
160,001 – 200,000	63,424	68·8	41·1
200,001 – 240,000	76,041	81·5	46·4
240,001 – 280,000	86,211	81·5	46·4
280,001 – 320,000	96,260	85·7	49·4
320,001 – 360,000	106,367	94·6	56·2
360,001 – 400,000	116,012	110·3	75·2
Exceeds 400,000	116,012	110·3	75·2

Notes:
Where reimbursement is based on actual business kilometres travelled and no other compensation is paid to such employees and the kilometres travelled for business does not exceed 8,000, the prescribed rate is R2·92 per kilometre.

Tax rates of normal tax retirement lump sum benefits in respect of the year of assessment ended 28 February 2010

Not exceeding R300,000	0% of taxable income
Exceeding R300,000 but not exceeding R600,000	18% of each R1 of the taxable income exceeding R300,000
Exceeding R600,000 but not exceeding R900,000	R54,000 plus 27% of the taxable income exceeding R600,000
Exceeding R900,000	R135,000 plus 36% of the taxable income exceeding R900,000

Tax rates of normal tax withdrawal lump sum benefits in respect of the year of assessment ended 28 February 2010

Not exceeding R22,500	0% of taxable income
Exceeding R22,500 but not exceeding R600,000	18% of each R1 of the taxable income exceeding R22,500
Exceeding R600,000 but not exceeding R900,000	R103,950 plus 27% of the taxable income exceeding R600,000
Exceeding R900,000	R184,950 plus 36% of the taxable income exceeding R900,000

Rating formulae

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

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

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Question 1 begins on page 6.

Section A – BOTH questions are compulsory and MUST be attempted

1 MF Ltd is a medium sized manufacturer. MF Ltd is not a small business corporation or a listed company. The company is a registered value added tax (VAT) vendor.

The directors of MF Ltd have decided that the company should undertake some research and development activities (R&D). They are considering a number of options and would like advice on the income tax effects of these.

The following information may be relevant to your advice:

(1) MF Ltd can clear 10% of the factory it has been using for the last five years for manufacturing purposes for the R&D activities. The factory originally cost R17 million (excluding VAT) and MF Ltd has been claiming a 5% allowance on this factory building.

Alternatively, MF Ltd can purchase a newly constructed building on the land adjacent to the existing factory. The new building will be used 85% as office space for the company's administration division and the remaining 15% for R&D activities. This new building would cost R15 million (excluding VAT).

(2) MF Ltd intends to use three machines for its R&D activities:

(a) The first of these, Machine A, is currently used in the manufacturing process but will be used 100% for R&D purposes from the date these activities commence. Machine A, which had been acquired second-hand, originally cost R400,000 (excluding VAT) and has been depreciated by MF Ltd for the last four years.

(b) The second, Machine B, would be purchased new specifically for the R&D activities for a cost of R500,000 (excluding VAT). Alternatively, a used machine, Machine C could be purchased for a cost of only R350,000 (excluding VAT). Machine C will have a remaining useful life of at least three years if used for R&D purposes.

(c) The final machine, Machine D, will be purchased new on suspensive sale. The monthly instalments payable will amount to R13,350 per month for 60 months. The cash cost of Machine D is R600,000 (including VAT). Machine D can be used in both the R&D activities and the manufacturing process of MF Ltd. The directors are therefore considering using the machine 50% for R&D and 50% for manufacturing. However, they will consider using the machine 100% for the R&D activities initially and only later making the machine partly available to the manufacturing process, if this would be more tax efficient.

(3) Revenue costs relating to the R&D activities are anticipated to include:

(i) Engineering and laboratory technicians remuneration. These will all be local personnel who will be used exclusively for the R&D activities.
(ii) Share of existing administrative staff costs to manage the R&D activities.
(iii) Registration of the trademark over the name of the product produced from the R&D activities.
(iv) Consulting fee payable to MF Ltd's marketing team.
(v) Consumables to be used by the laboratory technicians.
(vi) Payments to personnel outside South Africa for technical services. All of these services will be rendered outside of South Africa.
(vii) Royalty payments to an offshore company for technical know-how.

Required:

Draft a memorandum to the directors of MF Ltd in which you:

(i) **Advise on the income tax allowances available from the use of the current factory building and the purchase of the newly constructed building to house the R&D activities;** (13 marks)

(ii) **Advise on the income tax deductions available in respect of each of the machines to be used for the R&D activities. Where alternative claims are possible, advise as to the optimum claim;** (17 marks)

(iii) **Set out the income tax effect of each of the revenue costs anticipated as relating to the R&D activities.** (8 marks)

Notes:
1. You should assume that the R&D activities will be undertaken for a minimum of four years.
2. Your advice in (i) should be supported by relevant computations showing the effect of any specific allowances that can be claimed.

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

(40 marks)

2 Gerald Jamieson (aged 35), a tax resident of South Africa, has been offered an employment contract with a large multi-national corporation. In addition to their cash salary, which in Gerald's case will be R600,000 per annum, the multi-national corporation offers its employees' a number of options as part of their employment package.

Gerald would like to understand the tax consequences of each of these options before deciding on which to choose. At a recent meeting he provided you with the following information.

(1) The company is prepared to pay its employees' medical contributions for membership of the company approved medical aid scheme as part of their cost of employment. Alternatively, the employee will have to pay their own contributions to a private medical aid scheme. For either scheme the employee would be a member of the scheme. The monthly contributions for Gerald to either scheme would be R1,500 per month. He has no dependants.

(2) The company will pay a travel allowance of R5,000 per month where an employee uses their own car for business journeys. Alternatively, the employee can receive exclusive use of a company car. The cash cost of such a car would be R200,000 (excluding VAT) and the company would pay for the fuel and maintenance for this company car. No contribution to the cost of fuel or maintenance is made by the company where an employee uses their own car.

(3) The company offers both a pension fund and a provident fund. Employees have the option of contributing 8% of their cash salary to either one of the funds (but cannot contribute to both or to a combination of the two funds). The employer will contribute an equal amount to whichever fund is selected by the employee.

Required:

Write a letter to Gerald Jamieson in which you:

(i) Advise whether he should opt for his employer to pay contributions to the company approved medical scheme or whether he would be better off contributing, himself, to a private medical scheme; (7 marks)

(ii) Advise whether he would be better off opting for the travel allowance or the company car; (5 marks)

(iii) Explain the income tax consequences arising from the alternative pension arrangements offered to him, including the income tax consequences on receipt of the lumpsum from the fund on retirement. (6 marks)

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

(20 marks)

Section B – TWO questions ONLY to be attempted

3 The Kota Family Trust ('the Trust') was formed in South Africa by Ntombi Kota (aged 42). Ntombi and two independent trustees form the board of trustees. All the trustees are tax resident in South Africa.

The Trust holds the following donated assets:

(1) Participation rights in a South African collective investment scheme, donated by Ntombi.
(2) A rental property in Nigeria donated by Ntombi's husband, Wallace (aged 48). Wallace is a tax resident in South Africa.
(3) South African interest-bearing investments originally donated by Ntombi's mother, Hermina, who is now deceased. At the time of the donation Hermina was a non-resident.
(4) South African shares donated by Ntombi's father, Zolani, who is also now deceased. At the time of the donation Zolani was tax resident in South Africa.

The Trust's beneficiaries are: Zolani, Hermina, Wallace, Ntombi and Nomphelo. Nomphelo (aged 22) is Wallace and Ntombi's daughter and she is a non-resident.

The Trust earned the following income from the various assets in the year ended 28 February 2010 (all amounts have been translated into South African Rand at the appropriate rate):

(1) Distributions from the collective investment scheme (all made within 12 months of the portfolio receiving the income) of R330,000; comprising R120,000 South African interest, R150,000 South African dividends and R60,000 foreign interest.
(2) Foreign rental income of R300,000.
(3) South African interest of R150,000.
(4) South African dividends of R100,000.

The following distributions were made on 28 February 2008, the last day of the tax year of the Trust:

(1) An annual annuity to Ntombi (in terms of the Trust Deed) of R150,000, made *pro-rata* from the South African interest and South African dividends.
(2) A discretionary distribution to Nomphelo of R200,000, made *pro-rata* from the collective investment scheme.

The Trust had no retained income on 1 March 2009.

Required:

(a) Explain the South African income tax implications of the distributions made and the income retained in the year ended 28 February 2010 for the Trust, the respective donors of the trust assets and each of the beneficiaries. Your answer should clearly identify the nature and amount of any taxable income arising on and exemptions applicable to the respective parties. (16 marks)

(b) Explain how the annuity in terms of the Trust Deed could be made more tax efficient using any combination of the South African interest and/or South African dividends. (4 marks)

(20 marks)

4 Propco Ltd carries on the trade of renting out both commercial and residential property. The company is a registered value added tax (VAT) vendor on a monthly VAT cycle.

The company has two properties. The first property comprises both commercial rental space (shops) and residential rental space (flats). This building was purchased directly from the developer (a VAT vendor) for R10 million in a single instalment. Propco Ltd charges market related rentals on both the residential and commercial parts of this property.

The second property was acquired from a non-VAT vendor for R4 million. The settlement of the purchase price was made in two equal instalments over a two-month period. The building was acquired for conversion into offices and once the conversion had been done, the offices were rented out commercially at market related rents.

Propco Ltd has not performed as well as expected and the directors, who are also the company's shareholders, have decided to end the business. Consequently they are currently negotiating the sale of the company's assets (the two properties) to another rental company. This other rental company is also a registered VAT vendor.

Required:

(a) Explain how the VAT input would have been determined on each of the two buildings when they were acquired by Propco Ltd. (9 marks)

(b) Advise on the VAT implications of the proposed sale of the two buildings by Propco Ltd to the other rental company. You should consider all possible alternatives. (11 marks)

(20 marks)

5 Flat C Glenoaks cc (Glenoaks), a closed corporation with a member's interest of R10, was formed in 1992. On formation Glenoaks also received a loan from its then member, Colin, of R319,990. The loan was used to acquire a residential property, which was purchased on 1 October 1992 for R320,000.

Henry purchased the member's interest in Glenoaks from Colin on 1 October 2000. The terms of the agreement were as follows:

	R
Market valuation of member's interest	980,000
Purchase of member's loan account	180,000
Total consideration paid to the former member (Colin)	1,160,000

Since his acquisition of the member's interest, Henry has treated the residential property as his permanent home.

As Henry has no intention of renting out the residential property and would like to take advantage of the primary residence exclusion, he is considering transferring the residential property from the close corporation into his own name. However, he would first like some advice on the tax implications of such a transfer.

The following additional information is available:

1. Henry has no plans to liquidate or deregister the close corporation.
2. The current market value of the residential property is R2,100,000.
3. The member's loan has remained at R180,000.
4. The value of the member's interest is considered to be the difference between the property market value and the member's loan (i.e. R1,920,000).
5. The residential property as held by the close corporation had been valued as at 1 October 2001 at R1,300,000.

Required:

(a) Determine whether or not the proposed transfer of the residential property from Flat C Glenoaks cc into Henry's own name will qualify for the temporary exemptions/reliefs introduced in the Taxation Laws Amendment Act 2009 regarding the transfer of a residence from a close corporation. (5 marks)

(b) Assuming that the proposed transfer of the residential property does qualify, list the four tax exemptions/reliefs available to Henry and/or Flat C Glenoaks cc under the 2009 temporary provisions. (2 marks)

(c) Explain the income tax consequences for Henry, if having successfully made use of the 2009 temporary provisions to transfer the residential property from Flat C Glenoaks cc into his own name, he were to sell it for R3,000,000 on 1 July 2012. Support your explanations with relevant calculations. (13 marks)

(20 marks)

End of Question Paper