Answers

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Tax Advisor
Firms Address

The Directors
The Local Company Ltd
Client's Address

1 June 2010

Dear Sirs

Please find below explanations in respect of the information supplied regarding finance leases, instalment sales and the elective provision of s.9D(13). Each of these issues is considered in turn below.

(a) Finance lease arrangement

Value added tax (VAT)
The finance lease represents an instalment credit agreement for VAT purposes. As such the VAT output payable in terms of the lease (R168,000, being R1,368,000 x 14/114) would have been paid at the start of the lease. There are no further VAT consequences when the lessee acquires the machine at the end of the lease.

Income tax
As the VAT implications are recognised at the start of the lease, the subsequent lease receipts are recognised.

During the lease, the lessor is entitled to claim a capital allowance dependent on the use by the lessee. The 'cost' for the purposes of claiming the allowance is based on the cash cost (excluding VAT as required by the Income Tax Act) and reduced by the agreed residual value in terms of the lease**. As the market value was equal to the cash cost (including VAT), the market value effects are equivalent to such cash cost and do not generate a lower value to consider for capital allowance purposes. The output VAT is added to the cost.

The sale of the leased asset to the lessee at the end of the lease will result in a recoupment of the allowances claimed during the lease if the sales price is greater than the tax value or where the tax value is greater than the sales proceeds, at the election of Localco, a loss allowance may be claimed for the difference between such tax value and the proceeds paid.

Capital gains tax
The disposal of the asset at the end of the lease will have capital gains tax consequences. Proceeds will be the residual value in terms of the lease (sales price) and not market value provided that the parties are unconnected.* Proceeds will be reduced by any recoupment (see above). The base cost will be the acquisition cost (net of VAT) less the allowances to date and the loss allowance (if any – see above). The capital gain or capital loss resulting will be aggregated with the other capital gains and capital losses to determine whether Localco has a net capital gain (of which 50% would be included in taxable income as a taxable capital gain).

(b) Instalment sale arrangement

Value added tax (VAT)
The instalment sale arrangement is an instalment credit agreement for VAT purposes. The implication is that the VAT is payable at the start of the instalment sale. The amount to be paid is R210,000 (R1,710,000 x 14/114).

Income tax
The instalment sale agreement results in the accrual of the proceeds for sale of the machine on entering into the agreement. The value to be recognised immediately is the cash value (excluding VAT). The finance charges are recognised on a yield to maturity basis. A deduction for the cost of the asset acquired (net of input VAT) is claimed as the machine represents trading stock.

As the instalment sale agreement results in immediate recognition of the sale proceeds whereas the actual cash flows in terms of the agreement are very different, relief is granted in terms of the debtors allowance. The allowance provides that the gross profit element of the debtors balance at the end of the year of assessment is recognised as a deduction and reversed at the start of the next year of assessment. The allowance therefore allows for the mis-match in timing between cash flows and accruals.

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* Interpretation Note 47 refers

(c) Dividends you receive from Foreignco will be taxable at the South African rate of 28% with no credit for the fact that the dividend has been paid out of profits earned in Ruritania which have suffered Ruritanian tax at 14%. Foreign dividends received by South African companies holding at least 20% of the equity shares and voting rights in the paying company are exempt from South African tax but your company holds only 15%. Other grounds for exemption would be that Foreignco is dual listed (one of the listings being the JSE Securities Exchange) or to the extent that the profits of Foreignco are derived from South African sources, but neither of these apply.

South African tax of R21,000 (R500,000 x 15% (holding) x 28% (company tax rate)) would be incurred.

However, because you own between 10% and 20% of Foreignco, it is open to your company, Localco, to make an election* to treat your proportionate share of the pre-tax profits in Foreignco as if they had been earned by Localco. If this is done, a proportionate share of the Ruritanian corporation tax suffered by Foreignco will be available as a tax rebate against the South African tax on the share of the profits. Because you would be taxed on 15% of the net income of Foreignco (determined as if Foreignco is a controlled foreign company) for the year, rather than just your share of the dividends paid by Foreignco, the dividend you receive may be exempt. The dividend is merely a distribution of post-tax profits, so to the extent that the dividend received is less than the share of net income included in Localco's taxable income, it is exempt. However, to the extent that the dividend is larger than the share of post-tax profits, say, because it had been paid out of profits of previous years, then it would only be exempt up to the amount of pre-tax profits taken into account for South African tax purposes under the election.

Effectively, this election treats your investment in Foreignco as if it were an investment in a controlled foreign company. However, Foreignco is not a controlled foreign company because less than 50% of the participation and voting rights are held by South African residents. This is so even though Foreignco is not classed as a 'foreign business establishment' and is resident in a low tax jurisdiction.

A comparison of the tax liabilities is given below:

	Election to be taxed on 15% of Foreignco's net income for its tax year is made	No such election is made
	R	R
Income subject to tax:		
Share of profits before tax: 3,000,000 x 15%	450,000	No inclusion
Dividend received: 500,000 x 15%	Exempt	75,000
South African tax at 28%	126,000	21,000
Foreign tax rebate (credit):		
450,000 x 14%	(63,000)	nil
South African tax payable	63,000	21,000

As the tax liability would be greater with the election, the election should not be made.

* under S9D(13)

2 (a) Mary

Mary receives an annual annuity of R250,000 from the Trust. The composition of the annuity retains its nature as the Trust is a mere conduit for such income. This means that the annuity comprises:

South African rental income (R250,000 x R300,000/R1,000,000) = R75,000
Foreign rental income (R250,000 x R450,000/R1,000,000) = R112,500
South African interest (R250,000 x 150,000/1,000,000) = R37,500
South African dividends (R250,000 x 100,000/1,000,000) = R25,000

Despite the annuity components retaining their nature, Mary cannot apply the dividend exemption to the dividend component as this is expressly denied in the Income Tax Act where the dividends are paid in the form of an annuity.

Mary is, however, entitled to the interest exemption of R30,000 which can be applied to the interest of R37,500 and the taxable dividends of R25,000 up to a combined maximum of R30,000 for the year (as she is over 65 years of age).

Mary will also be taxed on the dividends retained in the Trust (as the donor of the asset) [in terms of s.7(5)].

Joseph

Joseph is a non-resident from a South African tax perspective. He has received R200,000 from foreign source income from a non-resident Trust. He will not be taxed on such distribution as there is no South African gross income.

However, Henry as the resident donor of such foreign property that has benefited a non-resident will be taxed on such distribution [in terms of s.7(8)].

In addition, Henry will be taxed on the foreign rentals retained in the Trust [in terms of either s.7(8) or s.7(5)].

Janine

Janine is a minor child. The distribution of R200,000 was for her maintenance (being school fees and boarding). Janine will not be taxed on such amount as it arose from a donation from her parents (Rachael donated the interest bearing investments).

Rachael will be taxed on the distribution to Janine [in terms of s.7(3)]. That the distribution was for maintenance purposes is irrelevant as this form of benefit for minor children is specifically included.

Rachael will also be taxed on the South African interest retained by the Trust [in terms of s.7(5)].

The Trust

As Donald is dead, the Trust must be considered for any income not distributed for the property donated by Donald. As the property is located in South Africa, the rentals are of a South African source and the Trust will therefore be taxed on the rentals retained by the Trust.

(b) That the Trustees will now all be South African resident would seem to indicate that the Trust is now effectively managed in South Africa.

As the Trust was formerly non-resident by virtue of the Isle of Man Trustees control, the change of residence will have South African income tax implications.

The Trust will be deemed to have disposed of all its assets (other than immovable property in South Africa or assets of a permanent establishment) at market value on the date residence changed, and will be deemed to have reacquired such assets at that same market value.

This deemed disposal and acquisition sets the base cost of the relevant assets to be used in computation of capital gains on future disposals.

The South African immovable property donated originally by Donald will not be affected by such deemed disposal being immovable property in South Africa.

(c) A change of Trustees is a specific disclosure required on the IT12TR form (the annual return) for the Trust to the South African Revenue Service (SARS).

Omission would represent a material non-disclosure and SARS would be able to reopen the assessment at any time if the omission were to take place.

As a professional, such omission represents unethical behaviour that cannot be permitted.

Should Henry insist on non-disclosure, it would be necessary to inform him that our service would have to be discontinued, and that there is an obligation to inform SARS of such material non-disclosure.

3 John Walker

(a) Should John sell the business into a corporate entity, such as a close corporation or a company, as a separate person the company could register as a micro business provided it met the turnover registration requirements.

The 'qualifying turnover' for the registration must be below R1,000,000.

Such qualifying turnover excludes capital amounts and certain exempt amounts (not relevant here).

As the sales of capital assets generate capital amounts, the qualifying turnover is R850,000 and therefore below the threshold of R1,000,000.

The business (in the form of a company) can register as a micro business.

(b) If the close corporation is registered as a micro business, the tax is levied on taxable turnover based on a progressive table.

The taxable turnover based on the information above will consist of the revenue amounts plus 50% of the capital receipts i.e. R850,000 + 50% x R200,000 = R950,000

Micro business tax on the taxable turnover will be: R20,500 plus 7% x (R950,000 less R750,000) = R34,500

If the company was subject to normal tax (and is not a personal service company), the taxable income would comprise:

Sales	850,000
Less cost of sales and other deductions (550,000 plus 100,000)	(650,000)
Add taxable capital gains (R200,000 – 125,000) x 50%	37,500
Taxable income	237,500
Tax at 28%	66,500

It is therefore beneficial for John's close corporation to register as a micro business.

(c) The interest on the investments donated to Jenny will be deemed to be John's as the donation had as its sole or main purposes the reduction of John's tax liability.*

(d) Firstly, only the interest accruing after the donation can be said to accrue to Jenny, so the disclosure of only half the interest for the year would be incorrect.

Secondly, all the interest is taxable in John's hands.*

Finally, as it would be an act of evasion to declare only half the interest. Knowing the above, John should be informed that you cannot act on his behalf unless the appropriate disclosure on the return is made.

(e) John's intention on acquisition was capital in nature as he planned to build a commercial rental building.

The high offer prompted John to sell the property.

This is not necessarily a scheme of profit making but may be the realisation of the asset to best advantage (Stott's case).

It is therefore concluded that the sale is of a capital nature.

* as s.7(2) applies,

4 Liz

(a) Value added tax (VAT) Implications

(i) Option 1

The sale of the furniture, equipment and stock on hand to Gert will give rise to output VAT of $^{14}/_{114}$ of the selling price if it is sold before Liz de-registers as a VAT vendor.

If Liz de-registers as a VAT vendor before selling the furniture, equipment and stock an output VAT charge* will arise in respect of any items on hand on the de-registration date.

The output VAT is then calculated at $^{14}/_{114}$ on the lower of cost or market value.

Output VAT will be levied at 0% on goods which are zero rated e.g. certain foodstuffs.

(ii) Option 2

If Liz sells the whole enterprise to Joanne, VAT can be levied at the zero rate. Certain conditions must be met as follows:

- The business must be a going concern before and after the sale.
- To be considered a going concern the business must (a) be an income earning structure; and (b) all assets necessary to such income earning structure must be transferred to the purchaser.
- The purchaser must be registered as a VAT vendor at the time of sale.
- The sale agreement must be in writing and state that it is a sale at the zero rate.

Otherwise the standard rate applies.

* per s.8(2)

(b) Income tax implications

Options 1 & 2

The sale of the furniture and equipment will give rise to a recoupment or a tax loss deduction.

If sale proceeds (less VAT) exceed the tax value of the furniture there will be a recoupment.

A capital gain will arise if the proceeds exceed the tax cost of the asset, thus capital gains tax may be payable.

An income tax loss will occur if the tax value of the furniture is greater than the proceeds (less VAT). This loss will be allowed as a deduction [under s.11(o)].

All the above will apply to the sale of the equipment.

Any proceeds (less VAT) from the sale of trading stock will be included in gross income.

(c) By paying the waiters remuneration (whether in cash or otherwise), Joanne is an employer.

As a result, Joanne must register as an employer, irrespective of whether there would be any withholding of employees tax.

5 Patricia Ngula

(a) The receipt of R1·50 per share needs to be split into two parts.

Firstly, the excess above the share capital returned (paid from revenue reserves) represents a dividend.

As a South African dividend receipt, the dividend is exempt.

The share capital returned represents a capital distribution. This generates a partial disposal of the share.*

The capital distribution of R0·50 x 10,000 shares = R5,000 is treated as the proceeds from partial disposal.

The base cost to be allocated to the disposal is determined as capital distribution divided by the market value of the shares immediately before the capital distribution multiplied by the base cost of the shares before the capital distribution i.e. R5,000 (capital distributions)/R18 x R14 = R3,889

The value on 1 October 2001 is taken into account as the capital distribution from 2003 is only taken into account on an actual disposal of the shares (treated as proceeds) and does not affect the base cost.

The capital distribution on 1 July 2000 is also ignored as this capital distribution would have reduced the expenditure prior to 1 October 2001. That would only impact the determination of time apportioned base cost. As the market value was adopted by Patricia, the prior capital distributions are imputed in the share price.

* per paragraph 76A of the Eighth Schedule to the Income Tax Act

(b) Proceeds on disposal of the shares will include the receipt of R21 per share plus any capital distributions received on or after 1 October 2001 but before 1 October 2007, as the shares were held for this entire period.

The capital distributions received on or after 1 October 2007 have already been considered above.

The transaction on 16 September 2003 was partially a dividend and partially a capital distribution.

The portion recognised as a dividend would have been included in Patricia's gross income in the 2004 year of assessment.

The capital distribution (being the return of original share premium) would have been deferred until the disposal of the shares. The capital distribution is 50% x R5 x 10,000 shares = R25,000.

The proceeds on disposal of the shares are therefore R21 x 10,000 + R25,000 = R235,000.

Base cost represents the base cost remaining after considering those capital distributions received on or after 1 October 2007, namely R140,000 less R3,889 = R136,111.

Patricia will therefore have a capital gain of R98,889 to aggregate with her other capital gains and capital losses for the 2010 year of assessment.

		Marks
1	**The Local Company Ltd**	
(a)	Finance lease arrangement	
	Instalment credit agreement	1
	VAT output determined at start of lease and no further VAT consequences	2
	Lease receipts are gross income	1
	Lessor entitled to claim capital allowance	1
	How cost determined for allowance purposes	3
	Possible recoupment or loss allowance and derivation thereof	2
	Capital gains tax consequences of disposal	1
	How proceeds and base cost determined	2
	Capital gain/loss aggregated with other capital gains/losses	1
		14
(b)	Instalment sale arrangement	
	Instalment credit agreement	1
	Calculating VAT output	1
	Proceeds (excluding VAT and finance charges) are gross income	1
	Finance charges recognised on yield to maturity basis	1
	Deduction of machine acquired as trading stock	½
	Debtors allowance will apply	½
	Application of the debtors allowance	1
		6
(c)	Foreignco not a CFC, dividend to be taxed	1
	Foreign dividend exemptions do not apply (with list)	2
	No rebate for foreign taxes applied	1
	Determining the South African tax liability	1
	Effect of election to be a CFC	1
	Determining amount of net income to be taxed	1
	Determining foreign tax rebate	1
	Foreign dividend exemption can apply	½
	Determination of exemption	1½
	Determining South African tax and rebate	2
	Conclusion	1
		13
	Format and presentation	2
	Total	**35**

			Marks Available	Maximum
2	(a)	**Mary**		
		Annuity retains its nature	1	
		South African rental income	½	
		Foreign rental income	½	
		South African interest	½	
		South African dividends	½	
		Cannot apply dividend exemption with reason	1	
		Interest exemption can apply with treatment and reason	2	
		Taxed on the dividends retained	1	
		Joseph		
		No tax as no South African gross income	1	
		Henry taxed on distribution	1	
		Henry taxed on the foreign rentals retained	1	
		Janine		
		Janine not taxed as amount arose from a donation from her parents	2	
		Rachael taxed on the distribution	1	
		Rachael taxed on the South African interest retained	1	
		The Trust		
		Consideration of any income and treatment of rentals	2	
			16	14
	(b)	Trust managed in South Africa		1
		Change of residence has South African income tax implications		1
		Treatment of assets		1
		Sets base cost		1
		Immovable property not affected		1
				5
	(c)	Disclosure required		1
		Omission is material non-disclosure with consequences		1
		Omission unethical and not permitted		1
		Impact if Henry insists on non-disclosure		1
				4
		Professional marks:		
		Format and presentation		1
		Clarity		1
				2
			Total	**25**

			Marks
3	**John Walker**		
	(a)	Can register provided meets requirements	1
		Qualifying turnover	½
		Excludes capital amounts and certain exempt amounts	½
		Qualifying turnover below threshold	½
		Conclusion	½
			3
	(b)	Tax levied on taxable turnover based on a progressive table	1
		Taxable turnover and calculation	2
		Micro business tax calculation	1
		If the company was subject to normal tax:	
		Sales	½
		Cost of sales and other deductions	½
		Taxable capital gains	1
		Tax at 28%	½
		Conclusion	½
			7
	(c)	Deemed to be John's with reason	2
	(d)	Disclosure incorrect with reason	1
		Taxable in John's hands	1
		Act of evasion and result	2
			4
	(e)	Intention	1
		Prompted	1
		Not necessarily a scheme of profit making	1
		Conclusion	1
			4
		Total	**20**

				Marks
4	**(a)**	**(i)**	**Option 1**	
			If furniture, equipment & stock sold before deregisters	
			Output VAT $^{14}/_{114}$ of selling price	1
			If furniture etc sold after deregisters	
			Output VAT on items held on de-registration date	1
			Output VAT $^{14}/_{114}$ on lower of cost or market value	2
			Output VAT 0% on zero rated items	1
				5
		(ii)	**Option 2**	
			Conditions for zero rating sale	1
			Going concern before and after sale	1
			Going concern definition (1 mark per point, max 2)	2
			Purchaser registered VAT vendor	1
			Written agreement states sale zero rated	1
			Else sale standard rated	1
				7
	(b)		**Options 1 & 2**	
			Recoupment if sale proceeds (net of VAT) exceed tax value	1
			Capital gains if proceeds exceed tax cost	1
			Tax loss if tax value greater than proceeds (net of VAT)	1
			Tax loss allowed as deduction	1
			Proceeds from trading stock (net of VAT) included in gross income	1
				5
	(c)		Payment of remuneration	1
			Is an employer as defined	1
			Must register as an employer	1
				3
			Total	**20**

			Marks
5	**Patricia Ngula**		
	(a)	Excess represents a dividend	1
		Dividend exempt	1
		Represents a capital distribution and generates a partial disposal	2
		Capital distribution treated as the proceeds from partial disposal	1
		Base cost and calculation	2
		Value on 1 October 2001 taken into account with reasons	2
		Capital distribution on 1 July 2000 ignored with reasons	2
			11
	(b)	Proceeds on disposal	1
		Capital distributions already considered	1
		Partial dividend and partial capital distribution	1
		Dividend portion included in Patricia's gross income, in correct year	½
		Treatment of capital distribution	1½
		Proceeds on disposal calculation	1
		Base cost and calculation	2
		Capital gain and treatment	1
			9
		Total	**20**