Professional Level – Options Module

Advanced Taxation (South Africa)

Monday 6 June 2011

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 2–4

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

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SUPPLEMENTARY INSTRUCTIONS

1. You should assume that the tax rates and allowances for the tax year 2011 will continue to 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 2011/31 March 2011

Rebates	
Primary rebate	R10,260
Secondary rebate (over 65)	R5,675
Interest exemption	
Under 65	R22,300
Over 65	R32,000
Medical contribution rates	
Single member	R670
Member plus one dependant	R1,340
Each subsequent dependant	R410
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 2011

Where the taxable income	
does not exceed R140,000	18% of each R1 of the taxable income
exceeds R140,000 but does not exceed R221,000	R25,200 plus 25% of the amount over R140,000
exceeds R221,000 but does not exceed R305,000	R45,450 plus 30% of the amount over R221,000
exceeds R305,000 but does not exceed R431,000	R70,650 plus 35% of the amount over R305,000
exceeds R431,000 but does not exceed R552,000	R114,750 plus 38% of the amount over R431,000
exceeds R552,000	R160,730 plus 40% of the amount over R552,000

Tax rates for small business corporations for the year of assessment ending 31 March 2011

R0 – R57,000	Nil
R57,001 – R300,000	10% of the amount over R57,000
R300,001 and above	R24,300 plus 28% of the amount over R300,000

Turnover tax rates for micro business corporations for the year of assessment ended 28 February 2011

R0 – R100,000	Nil
R100,001 – R300,000	1% of the amount over R100,000
R300,001 – R500,000	R2,000 + 3% of the amount over R300,000
R500,001 – R750,000	R8,000 + 5% of the amount over R500,000
R750,001 – R1,000,000	R20,500 + 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 2011

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 2011

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

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

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

Section A – BOTH questions are compulsory and MUST be attempted

1 Dr Miles Badroodien and Dr Brian Saxe run a medical practice in partnership. The partnership is registered as a vendor for value added tax (VAT). The partners (Drs Badroodien and Saxe) have also contracted with four other doctors to act as 'associates' to the practice. Dr Karen Silwa is one of these associates. None of the associates are registered for VAT.

The partners would like to understand the tax position of Dr Silwa, and at a recent meeting they provided you with the following information.

All patients of the partners and associates are billed by the partnership. The partners take 40% of all the associates' billings (net of VAT) as a recovery of operating overheads (such as the practice rental, electricity etc) in accordance with the associate agreement entered into between the partnership and its associates.

The associates are paid the remaining 60% of their billings (net of the VAT charged by the partnership). Each associate has their own consulting room to see patients and is responsible for furnishing the room, maintaining a stock of medicines to administer to patients, and determining the number of hours they work in any month.

The partners each bill approximately R1,500,000 per annum before VAT is added. Dr Silwa bills patients R1,200,000 per annum before VAT is added by the partnership, whereas the other associates work part-time and each only bills patients approximately R400,000 per annum before VAT is added by the partnership.

Required:

Write a letter to the partners, in which you:

(i) **Discuss whether or not Dr Silwa is an employee of the partnership or an independent contractor to the partnership, referring to both the statutory and common law tests;** (13 marks)

(ii) **Explain what amounts may constitute 'gross income' for the partners and for Dr Silwa, highlighting any areas of uncertainty;** (6 marks)

(iii) **Discuss the value added tax (VAT) implications for the partnership and Dr Silwa if Dr Silwa is an independent contractor.** (4 marks)

Professional marks will be awarded in question 1 for the appropriateness of the format and the presentation of the letter and the effectiveness with which the information is communicated. (2 marks)

(25 marks)

2 Global Products Ltd is a South African resident company buying and selling products globally. The company has a 31 March 2011 year end, and is a value added tax (VAT) vendor.

The shareholder structure of Global Products Ltd consists of:

(i) Foreign Holding LLC which holds 40% of the 10 million listed equity shares (each with a par value of R1) of Global Products Ltd;

(ii) Various shareholders holding the remaining listed equity shares. Of these shares only 5% are held by non-resident shareholders.

You have been approached by your audit manager for information of the tax consequences of the following transactions as detailed below.

(1) Foreign Holdings LLC increased its rand demoninated loan to Global Products Ltd from R50 million to R60 million on 1 December 2010. Simple interest of 13% per annum is charged on the loan balance. The prime rate of interest in South Africa has been 10% for the year of assessment.

The loan was made to fund capital asset acquisitions.

In addition, the following balances are provided at 31 March 2011:

Retained income	R25,000,000
Revaluation reserve	R12,000,000

(2) Global Products Ltd sources much of its trading stock from overseas markets for resale in South Africa and in other overseas markets. Certain goods were purchased and shipped to South Africa on 20 February 2011 from the company's one overseas supplier. The goods cost US$1,200,000 and the spot exchange rate at 20 February 2011 was US$1 = R7·30. This amount due to the supplier was payable in three equal instalments, being 28 February 2011, 31 March 2011 and 30 April 2011. Customs and excise charges of R360,000 were payable on the goods arrival at the dock (15 March 2011 – the deemed import date) and the value of the goods for customs and excise purposes was R9,060,000.

Global Products Ltd was concerned about exchange rate fluctuations with regard to the final payment of US$400,000, as payments 1 and 2 resulted in an aggregate exchange loss of R180,000 for accounting and tax purposes. However, the final payment resulted in an exchange gain of R20,000 for accounting and tax purposes.

The goods arrived in South Africa by ship on 15 March 2011 and were immediately sold to a customer in the United Kingdom for £1,500,000. The exchange rate on 15 March 2011 was £1 = R11·25. The terms provided to the customer provided for two equal instalments, the first being payable on ordering and the second being payable on 15 May 2011. There was a loss on translation of the debt for accounting and tax purposes with respect to the initial instalment of R187,500 as at 31 March 2011, and the receipt of the second instalment on 15 May 2011 resulted in a further exchange loss of R75,000.

(3) Global Products Ltd is considering an investment into a joint venture company (JV Company) with an unconnected non-resident company. The JV Company will operate in various tax jurisdictions outside of South Africa from rented premises.

The non-resident party has asked Global Products Ltd to supply the majority of the management team and requested that some of the Global Products Ltd staff be seconded to the JV Company's premises (outside South Africa).

You are also supplied with the basic definition of a 'permanent establishment' as contained in Article 5(1) of the OECD Model Convention on Income and on Capital, being:

'a fixed place of business through which the business of the enterprise is wholly or partly carried on'.

Required:

(a) Draft a memorandum to the audit manager in which you explain the tax consequences of transactions (1) and (2) above for Global Products Ltd. (23 marks)

Professional marks are awarded in part (a) for the appropriateness of the format and presentation of the memorandum and the effectiveness with which the information is communicated. (2 marks)

(b) For the company to be formed in (3) above, advise:

(i) whether or not the JV Company is resident for South African tax purposes; and

(ii) whether or not the JV Company represents a 'permanent establishment' of Global Products Ltd in terms of the factors arising from the basic definition, namely:

- **That the JV Company has a place of business;**
- **That the place of business is 'fixed'; and**
- **That the business of the enterprise (Global Products Ltd) be conducted through that place of business.** (10 marks)

(35 marks)

Section B – TWO questions ONLY to be attempted

3 Company M (Pty) Ltd ('Co M') and Company T (Pty) Ltd ('Co T') are both 80% held by Holding Company Ltd (Hold Co). Co M manufactures two different products on two different manufacturing lines from raw materials. Co T sells the finished goods produced by both manufacturing lines of Co M. All the companies have the same financial and tax year end, and all companies are value added tax (VAT) vendors.

During the year of assessment ending 31 March 2011, Hold Co suggested to the directors of Co M and Co T that the group would be better served if each of Co M and Co T housed one manufacturing line, i.e. each company will manufacture and sell one of the products. Having assessed the business model, the directors of Co M and Co T agreed with the suggestion from Hold Co and entered into the following transactions:

(1) Co M will sell the machinery comprising manufacturing line (and product) A to Co T at the current tax value of the machinery (exclusive of VAT). The tax value is less than the current market value.

(2) Co M will sell the raw materials applicable to Product A to Co T at its acquisition cost (exclusive of VAT).

(3) Co T will sell its current holdings of Product B to Co M at market value (exclusive of VAT).

No elections in terms of any provision of fiscal legislation have been made by Co M or Co T in respect of the above transactions, notably the corporate rule concerning intra-group transactions will apply to the above information.

Required:

(a) Discuss the tax implications of transactions (1) to (3) above for Company M (Pty) Ltd ('Co M') and Company T (Pty) Ltd ('Co T') for the year ended 31 March 2011, assuming the trading stock acquired from Co T was not sold by the year end. (14 marks)

(b) Discuss the income tax implications if Co T had to sell the machinery (acquired from Co M) during the year ended 31 March 2012. (6 marks)

(20 marks)

4 John Odis died on 1 November 2010 at the age of 67. At the time he had been a South African tax resident in terms of the physically presence test in the Income Tax Act. He was considered to be ordinarily resident in the Bahamas. John is not a value-added tax (VAT) vendor.

During his life, John had created the Odis Trust ('The Trust') in the Isle of Man with its place of effective management outside of South Africa. The Trust was fully discretionary both as regards income and capital. John had sold a property in South Africa and interest bearing investments in the Bahamas to The Trust on loan account with no mention of interest or repayment terms. A market related rate of interest charged on such a loan would have been 10% per annum. The Trust had repaid some of the loan account, but an amount of R2·3 million was still owed to John at 1 March 2010 and no further repayments had been made by the date of his death. In his will, John left the loan account (i.e. the amount owed by the Trust) to his wife.

The Trust earned net rentals of R180,000 and interest of R120,000 evenly over the year ended 28 February 2011. The Trust also had some retained income from previous years from the interest bearing investments, out of which a distribution of R40,000 was made to John in the year ended 28 February 2011, before his death.

At the time of his death, John had a number of assets around the world. John owned a house in South Africa and another in the Bahamas. Both were mortgaged. The property in the Bahamas was considered his primary residence.

John also had insurance policies on his life, both in the Bahamas and in South Africa. His estate was the stated beneficiary for each policy.

Required:

Explain the income tax consequences for John and the estate duty consequences for John's estate arising from the above information.

(20 marks)

5 Mr Thomas has approached you for advice on the matter of the taxation of a pension annuity. The facts are as follows:

Mr Thomas was formerly a director of a South African resident company and belonged to that company's pension fund. On his retirement, Mr Thomas emigrated to Australia and ceased being a South African tax resident. He receives a pension annuity from the South African company's pension fund.

The pension fund (as 'employer' for the purposes of the Income Tax Act) has withheld tax on the pension annuity paid to Mr Thomas. Mr Thomas has never declared his pension annuity in his Australian tax returns (where he was considered for all purposes to be tax resident).

All Mr Thomas' services during his employment were rendered in South Africa to a South African company.

Mr Thomas is now concerned that tax should not be levied in South Africa, but rather in Australia. He would like your advice on the matter before approaching the Australian and South African Revenue Authorities.

The 'Pension' article from the South Africa–Australia Double Tax Agreement (DTA) provides:

'Article 18

Pensions and annuities

1. Subject to the provisions of paragraph 2 of Article 19, pensions and annuities from sources in one Contracting State [South Africa] and paid to a resident of the other Contracting State [Australia] shall be exempt from tax in the first mentioned Contracting State [South Africa] to the extent that such pensions and annuities are included in taxable income in the other State [Australia].
2. […]
3. The term 'annuity' means a stated sum payable periodically at stated times during life or during a specified or ascertainable period of time under an obligation to make the payments in return for adequate and full consideration in money or money's worth.'

NOTE:
(i) Paragraph 2 of Article 19 concerns pensions for government service and does not apply to Mr Thomas.
(ii) The Contracting State names are inserted into the above article to assist your interpretation.
(iii) Paragraph 2 of the above article is deleted as it is not relevant to your analysis.

Required:

(a) Discuss whether or not Mr Thomas should be subject to tax in South Africa on the pension annuity considering only the Income Tax Act. (11 marks)

(b) Discuss whether or not the DTA with Australia will assist to minimise or remove the South African tax liability. (9 marks)

(20 marks)

End of Question Paper