Answers

Note: ACCA does not require candidates to quote section numbers or other statutory or case references as part of their answers. Where such references are shown below [in square brackets] they are given for information purposes only.

1 Report

To: Lebo Msuthu

From: ACCA Candidate

Subject: Tax queries with respect to value added tax (VAT) registration, retirement annuity fund contributions and the creation of a trust

Date: 4 December 2018

This report addresses the issues and questions you raised at our meeting on 1 December 2018. The questions have been addressed in turn below and I have, for ease of reference, stratified my comments under various sub-headings.

(a) VAT registration obligations and compliance issues

The South African Revenue Service (SARS) has clarified that the work of non-executive directors is not that of an employee and therefore is a separate taxable supply (service) made to the relevant company. As a result, non-executive directors are required to register for VAT where income (in the form of directors' fees) is in excess of the VAT compulsory registration threshold of R1,000,000. Since the income you have earned from your non-executive director positions in the 2019 year of assessment to date is currently R1,100,000, you are required to register for VAT.

We need to clarify with you urgently the point at which the income from these positions exceeded R1,000,000. The current compulsory VAT registration requirements stipulate that liability for registration arises at the end of any month where 'the total value of taxable supplies made by that person in the period of 12 months ending at the end of that month in the course of carrying on all enterprises has exceeded R1,000,000'. Once the liability to register has arisen (as is clearly the case here), the vendor has 21 business days from the point at which the liability for registration arose. If you are still within this window, you should urgently apply for VAT registration. If your application is submitted in time, the Commissioner for SARS will determine the date from which you must operate as a vendor. If the window in which the application to register as a vendor has passed, you must still urgently submit your registration application to operate as a VAT vendor. However, in this latter circumstance, you will become liable for VAT immediately after the 21 business day window. Discretion is granted to the Commissioner for SARS to grant a later effective date should the circumstances warrant such discretion to be applied.

If you are a registered e-filer, you may submit your application to register for VAT online.

Should you be in default for failure to register and/or failure to submit VAT returns, you may be subject to non-compliance penalties. In addition, you may be subject to late payment penalties in respect of any VAT unpaid by the return submission date. Most of these penalties may be remitted on application to the Commissioner for SARS if an approach is voluntarily made to SARS with respect to the non-compliance (and usually if you are a first-time offender).

(b) Tax benefits of retirement annuity funds

Contributing to a retirement annuity fund provides various tax benefits. The first, and most immediate, as highlighted by your financial adviser, is the income tax relief in respect of contributions to the retirement annuity fund. Currently, you earn an annual salary of R5,000,000, non-executive director fees (R1,100,000 in the year of assessment to date) and rental income from Property A which you lease out. Even if we exclude the income from Property A from the current debate (as you intend to contribute this property to a trust), you could achieve tax savings on contributions to retirement funds (including retirement annuity funds) up to a maximum contribution limit of the lower of R350,000 and 27·5% of your taxable income (which based on your income excluding rent from Property A amounts to R1,677,500 ((5,000,000 + 1,100,000) x 27·5%)). A contribution of R350,000 to a retirement annuity (assuming no other retirement fund contributions against your cash salary) would provide a tax saving of R157,500 (45% highest marginal rate x R350,000 maximum contribution).

The second benefit of contributing to a retirement annuity fund is that the returns on the capital contributed to the fund are untaxed in the fund. Returns do not accrue to you each year, instead, they increase the capital balance in the fund. This should be contrasted with the tax treatment of other investments you could make whereby you would be subject to tax on foreign dividends, interest and other streams of revenue (depending on the nature of the underlying investment). In addition, any transfers between asset classes (e.g. shares to bonds) would generate capital gains tax in standard investments. This is because the transfers would be treated as the sale of one asset in order to buy another. All such effects are avoided in a retirement annuity fund.

The third benefit arises on retirement. On retirement, all or part of the value of the retirement annuity fund can be withdrawn as a lump sum. Currently, the first R500,000 of any lump sum withdrawn would carry no tax and the next R200,000 would only be taxed at 18%. Any remaining balance may then be drawn as an annuity. Whilst the periodic amounts paid as an annuity are subject to tax, generally, the marginal rate for retired persons is lower than that for working individuals as a result of a decrease in income. Additionally, persons aged 65 and over enjoy additional rebates against income tax.

The fourth tax benefit would be on death with respect to estate duty. Retirement annuity fund balances are excluded from property for the purpose of estate duty. Only if in the extreme and unlikely event that contributions made to the retirement fund have exceeded the annual contribution limits and were not utilised against any lump sum payment, then such excessive contributions will form property in the estate. Note that the contributions not deducted should be considered against any lump sum withdrawal on retirement, i.e. should be exhausted.

(c) Transfer of Property A to the trust

1. **By donation**
   A donation of Property A to the trust would trigger an immediate 20% donations tax on the market value of the property (i.e. (R5,000,000 – R100,000 (assuming no other donations are made during the year)) x 20% = R980,000) which creates an immediate liquidity problem.

   As well as the donations tax, capital gains tax would be levied on the gain on the disposal of Property A to the trust. The capital gain would be determined as follows:

   Proceeds of R5,000,000 less the base cost. The base cost would comprise the acquisition cost of R1,000,000 and a portion of the donations tax paid, being R784,000 (R980,000 x [(R5,000,000 – R1,000,000)/R5,000,000]). This would lead to a capital gain of R3,216,000 (R5,000,000 – R1,784,000). Assuming the maximum marginal rate of 45%, the inclusion rate of 40% and that the annual exclusion is unused (and no other capital gains and losses have been generated in the year), the tax would be R571,680 [(R3,216,000 – R40,000) x 40% x 45%].

   The only advantage which a donation of Property A would bring would be its exclusion from your estate for estate duty purposes.

2. **By sale**
   If Property A were sold to the trust, then should the sale take place at full market value, there would be no element of donation and therefore no donations tax. However, should the sale take place at less than full market value, the difference between the consideration paid to you by the trustees and the market value would be considered a donation which would be liable to donations tax (with all the impacts above but on a proportional basis).

   The sale of Property A to the trust will generate a capital gains tax liability for you which would be slightly higher than if the property were donated due to the exclusion of donations tax from the base cost. The tax would be R712,800 [(R5,000,000 – R1,000,000 – R40,000) x 40% x 45%], but no donations tax liability has been incurred.

Acquisition funded by bank loan
Should the trust obtain a loan from a bank (on the basis that the property being acquired is for rental purposes and there would therefore be some income against which repayments can be funded), the tax implications for you would be limited to the capital gains tax on the disposal of the property to the trust.

However, you should be aware that the bank loan would carry interest, which would therefore reduce the amount of income available for distribution which would erode the trust mandate to primarily provide for the major child's maintenance while out of South Africa.

A full bank loan for the acquisition would result in a swap of Property A for cash. This cash may, in turn, be used to supplement your retirement savings in an annuity (but as this would be a contribution in excess of the annual income tax deduction limit, it may be included for estate duty purposes, but the income on the contribution would be shielded (see part (b))).

Acquisition funded by interest-free loan provided by you
There are a number of disadvantages for you if you were to make an interest-free loan to the trustees to enable them to purchase Property A. Apart from the attribution of actual trust income (apart from distributions to your husband by the trustees – see part (d)), the interest-free loan will result in the attribution of notional income to you equal to the amount of interest which would have been charged had the loan been granted on an arm's length basis. Further, the amount of interest foregone by you on the loan would be treated as a deemed donation from you to the trust. This deemed donation would be the difference between the income of the trust and the interest which would have been charged to the trust at the official rate of interest.

If you were to provide an interest-free loan to fully fund the acquisition of Property A (ignoring transfer costs and acquisition costs), the deemed donation would be: (R50,000 – R10,000) x 12 – R5,000,000 (property price and therefore illustrative loan amount) x 8% (official rate) = R80,000. Donations tax would therefore be R16,000 (being R80,000 x 20%, assuming the annual relief of R100,000 has been exhausted – if not, the donations tax will be nil).

(d) Income tax implications in respect of income earned in the trust

In the event that the property is donated to the trust or sold on interest-free loan account to the trust, the income earned in the trust will be fully attributable to you unless it is distributed to a major resident beneficiary (i.e. your husband). Your major child is currently non-resident and therefore any income distributed by the trustees to that child will be attributed to you with no limit. Further, any distributions to your minor child will also be attributed to you. Thus, the only income of the trust on which you would not be taxed personally would be that which is distributed to your husband. This means that the creation of the trust is unlikely to result in any significant income tax savings for you.

Should the trust obtain a bank loan to acquire the property, then the subsequent income will not be attributed to you, but will accrue to the beneficiaries, achieving lower income tax rates overall due to the effects of income splitting.

The above documents the key tax implications of the information as supplied. Should there be any further queries, I will be happy to assist.

Kind regards

ACCA Candidate

2 SupplyALL

(a) Value added tax (VAT) and customs duty implications of current distribution operations in South Africa and potential VAT implications arising from the proposed release of the e-book mobile application to the South African market

Import of electronic goods by customers
The import of goods by South African customers places the duty to report the purchase and to pay the associated customs duty and VAT onto the customer. Even though SupplyALL provides the service to clear these goods through customs, it does not mean that SupplyALL is required to register for VAT. The customs duties and import VAT may, however, be collected by SupplyALL from the customer in anticipation of the payments to be made.

SupplyALL's South African customers are therefore responsible for VAT on the goods they have imported. VAT is charged on the added tax value (ATV) which is determined as customs value plus any duty levied on the goods plus 10% of the customs value. For the goods which do not clear customs, but are immediately transported to other African countries, the goods carry no VAT or customs as they are not imported into South Africa but are in transit through the port of entry.

Distribution service staff and quality control expert
No VAT implications will arise as a result of the employment of the three distribution service staff as employment is not considered an enterprise.

The quality control expert is based in Country A and is an employee of SupplyALL. Despite SupplyALL being a registered VAT vendor in South Africa, this would be insufficient to render the employee's services in South Africa as an imported service (to the vendor itself).

Proposed release of mobile application
If the mobile application is launched in South Africa as planned, the supply of e-books via this application will require SupplyALL to register as a VAT vendor in South Africa. As a supplier of electronic services to South African residents, who will be making payment for e-books from South Africa, with billing addresses in South Africa, SupplyALL will be considered an enterprise for South African VAT purposes.

SupplyALL will become liable to register for VAT at the end of any month where the total value of taxable supplies exceeds R50,000. VAT at the standard rate must be charged unless the good is one for which the zero rate applies (which appears unlikely in this case). Despite the fact that the servers are located in Country A and prices are denominated in Country A's local currency, SupplyALL will have to charge VAT to its South African customers and pay this VAT over to the South African Revenue Service (SARS). This registration will require a representative vendor in South Africa to facilitate such payments.

(b) Risk of creating a permanent establishment in South Africa and consequences if SupplyALL were to set up a South African subsidiary

Currently, SupplyALL is unlikely to be considered to have a permanent establishment in South Africa. The company merely utilises a distribution warehouse for ease of goods clearing customs. It would seem that this function is auxiliary to the main business of SupplyALL which is the supply of electronic goods.

In addition, the limited South African staff and oversight from the head office in Country A would seem to indicate that the main functions are provided from outside South Africa. The e-book platform is also based entirely outside South Africa, with customers merely downloading the mobile application and ordering e-books for download via servers outside South Africa. The lack of permanent establishment would render the profits of SupplyALL not subject to tax in South Africa.

The lack of permanent establishment does not, however, prevent the levying of VAT by a representative vendor (as described part (a)).

If SupplyALL were to create a South African subsidiary to run its existing South African operations, incorporation in South Africa would render the subsidiary resident in South Africa. Should the subsidiary also be resident outside South Africa in accordance with domestic law in Country A (the location of SupplyALL's head office), then the dual residence would only be resolved by means of a tie-breaker clause in the double tax treaty. Should the treaty deem the residence to be Country A by reference to the place of effective management, the company would be a non-resident in South Africa.

As the South African subsidiary would merely house the existing business operations, if it is deemed to be non-resident in South Africa, the tax position under this new structure is unlikely to change.

Increasing the presence in South Africa with an administrative function and more seconded employees may begin to indicate less of an auxiliary function and the South African operations may be more likely to be considered part of the main business of SupplyALL. Should this be the case, a permanent establishment in South Africa would be created. This would render the profits taxable in South Africa, the allocation of which may be difficult to determine.

If housed in a subsidiary and the subsidiary is considered to be resident in Country A under the terms of the double tax treaty, the dividends declared up to the holding company in Country A would not bear dividends tax.

The VAT consequences will be unchanged.

(c) Tax implications and compliance requirements with respect to the three distribution service staff, visiting quality control expert and potential future employees/secondees

In order to pay staff in South Africa, SupplyALL should have appointed a 'representative employer' in South Africa responsible for the payment of the employees tax on the relevant wages paid to the South African employees. This agent must have the authority to pay the remuneration and be resident in South Africa.

The representative employer will therefore be responsible for withholding employees tax in respect of the distribution service staff and any administrative staff SupplyALL chooses to employ in South Africa in future.

The representative employer is not responsible for the deduction of employees tax for non-resident persons.

Whether employees tax will have to be withheld on the remuneration paid to the quality control expert visiting from head office in Country A and any head office employees seconded to South Africa in future will depend on whether SupplyALL is considered to have a permanent establishment in South Africa and whether that remuneration is considered to be borne by the permanent establishment.

(d) Criteria for the headquarter company regime to apply and suitable structure to make use of this regime

For SupplyALL to be a headquarter company, it would have to meet the following conditions:

– SupplyALL would have to create a South African resident company.
– For every year of assessment, each shareholder must hold at least 10% of the equity shares and voting rights in the South African resident company.
– At the end of the year of assessment (and all subsequent years), 80% or more of the cost of the total assets must be attributable to interests in equity shares, debt or intellectual property of a foreign company in which at least 10% of the equity shares and voting rights are held.
– Should the gross income of the South African resident company exceed R5,000,000, 50% or more of the income must consist of any combination of rental, dividend, interest or service fees payable by a foreign company or the proceeds from the sale of any interest in the foreign company (excluding any exchange differences).

In evaluating these criteria, first, SupplyALL would have to create a resident subsidiary. It could hold all of the shares in this subsidiary, but care should be taken to ensure that the subsidiary is not effectively managed outside South Africa. The business of the subsidiary should relate to holding subsidiaries created in Africa (outside South Africa) to ensure that the assets are mainly interests in foreign companies and further that the income is mainly from foreign dividends (and possibly service fees if the services are rendered from South Africa to the other African subsidiaries). Note that any cash held in South Africa is excluded from the determination of the 80% threshold.

SupplyALL could therefore create a headquarter company for the African operations.

3 Joseph

(a) Sub A residence and controlled foreign company status

Sub A is incorporated in Mauritius. The only grounds on which Sub A would be considered to be resident in South Africa would be if the company is found to have its place of effective management in South Africa.

Joseph will have a significant involvement in Sub A as its managing director, but initially will only have a 49% shareholding. While clearly significant, he does not have a majority shareholding. Joseph will be tasked with making the day-to-day business decisions and all board meetings will take place in Mauritius. Joseph is himself highly mobile with the bulk of his client work taking place outside South Africa. This carries the implication that the day-to-day decision making does not take place mainly in South Africa. The clearest direction for the company would appear to come from the board meetings and so the location of those meetings (i.e. Mauritius) is likely to prevail as its place of effective management.

It is therefore unlikely that Sub A would be resident in South Africa for income tax purposes.

To be a controlled foreign company, the participation rights in Sub A (the foreign company) would have to be held in the majority by South African residents. Participation rights in this case are considered to be the holding of ordinary shares and voting rights when considered collectively. In this case, Joseph will only hold 49% of the equity shares and voting rights of the company and Mountain Ltd (resident in Mauritius) will hold 51%. Therefore Sub A will not meet the definition of a controlled foreign company.

(b) South African tax treatment of Joseph's Sub A salary and dividends and impact on retirement annuity fund contributions

The foreign dividends received from Sub A will qualify for the domestic participation exemption as Joseph's holding of the equity shares is greater than 10%. This will result in the foreign dividend being fully exempt for South African income tax purposes.

Joseph also earns a salary from Sub A of R2,000,000. This salary may be partially exempt from income tax. It is indicated that the bulk of Joseph's work is concluded outside South Africa. Should Joseph be outside South Africa for more than 183 days and a continuous absence of at least 60 consecutive days, Joseph may qualify for an exemption with respect to his salary as regards this foreign service. This exemption would not have applied to Joseph's earnings as a sole trader as the exemption is only applicable to remuneration. The 183 days and continuous absence of 60 days may occur across years of assessment and are applicable to a 12-month period. Based on the information supplied, these conditions are met and R1,041,096 (190/365 x 2,000,000) of Joseph's salary will be exempt from income tax.

This exemption will have a direct impact on the amount of the retirement annuity fund contribution which is deductible as it will reduce Joseph's taxable income. The deduction limit for retirement annuity fund contributions is the lower of R350,000 or 27·5% of the taxable income before the deduction. In this instance, the deduction will be limited to R263,699 (27·5% x (2,000,000 – 1,041,096)). The excess contribution is carried forward to the following year of assessment. Excess contributions will continue to be carried forward until they are utilised in full or retirement.

(c) After-tax cash position for Joseph if he sells or does not sell his business

		Does not sell	Sells
	R	R	R
Income tax			
Freelance earnings		2,000,000	
Salary from Sub A			2,000,000
Exemption for foreign service remuneration 190/365 (as in (b))			(1,041,096)
Foreign dividend – exempt (as in (b))			0
No controlled foreign company (see above)			0
Travel expenses (140,000 + 70,000)		(210,000)	
Sub-total		1,790,000	958,904
Retirement annuity fund (RAF) deduction:			
Freelance (lower of 27·5% x 1,790,000 or 350,000)		(350,000)	
Salary (as in (b))			(263,699)
Taxable income		1,440,000	695,205
Tax per the tax tables:			
(209,032 + 41% x (1,440,000 – 708,310))		509,025	
(149,475 + 39% x (695,205 – 555,600))			203,921
Less rebate		(13,635)	(13,635)
Tax liability		495,390	190,286
Net cash from freelance (2,000,000 – 210,000 – 500,000 (RAF contribution) – 495,390 (income tax))		794,610	
Cash from earnings from Sub A (2,000,000 – 500,000 (RAF contribution) – 190,286 (income tax))			1,309,714
Dividend from Sub A:			
Profit	8,000,000		
Expenses (600,000 + 3,500,000)	(4,100,000)		
Profit	3,900,000		
Less Mauritian tax at 15%	(585,000)		
Profit after tax	3,315,000		
Dividend to both shareholders (50% x 3,315,000)	1,657,500		
Withholding tax on dividend at 10%	(165,750)		
Net dividend	1,491,750		
Joseph's share of net foreign dividend (49% x 1,491,750)			730,958
Net cash		794,610	2,040,672

Conclusion: From an after-tax cash perspective, it would be beneficial for Joseph to sell his business.

4 Engineering SA Co Ltd (ESC)

(a) Actions the South African Revenue Service (SARS) would take in a transfer pricing audit

The actions SARS would take in a transfer pricing audit of ESC would include:

– a review of ESC's transfer pricing documentation to determine the quality of the documentation and the commerciality of its profit outcome;

– a list of queries sent from SARS to ESC to obtain further information about transfer pricing practices;

– a request for ESC to send a representative to answer queries in person for SARS to determine how the transfer pricing policies were applied during the year (or any other year under investigation);

– an on-site inspection to search for more relevant documentation (not search and seizure).

SARS would then send ESC a list of findings setting out the results of the audit and its conclusions, indicating what action it may take (with the opportunity for ESC to respond). If agreement cannot be reached between SARS and ESC, SARS would then issue an assessment based on its findings.

Any dispute remaining would then be dealt with in accordance with the usual dispute resolution process; ESC could object to the assessment and the matter would then proceed to the tax court if SARS rejected the objection or the alternative dispute resolution process did not yield a satisfactory outcome.

(b) Supporting transfer pricing documentation

In order to minimise the risk of a transfer pricing audit being conducted by SARS, ESC should have compiled supporting transfer pricing documentation, including (but not limited to) the following:

– a functional analysis report, which outlines the functions performed and risks assumed by the respective parties involved, i.e. by EGG in Lowtaxia and by ESC in South Africa.

– an economic analysis to determine the basis for the transfer pricing method applied, i.e. an analysis of the financial data of comparable companies to determine their profit margins;

– a transfer pricing report, which contains the results of the above analyses and the applicable contractual arrangements and related documentation used to implement the transfer pricing policies between EGG and ESC.

EGG and ESC can use this documentation to demonstrate that the respective transfer prices have been determined having undertaken the required analyses and having made appropriate adjustments to take into account the differences between their intra-group transactions and those of independent comparables. Having such documentation in place shifts the burden of proof to SARS to show the prices as not being at arm's length.

(c) Acceptable transfer pricing methods and critical factors in making this decision

Neither the legislation nor SARS practice prescribes a particular method for determining the arm's length price. SARS recognises the methods set down in the OECD transfer pricing guidelines. The method most appropriate to the circumstances should be adopted and this will depend on the nature of the transactions taking place. Current SARS practice prefers traditional transaction methods. In identifying comparable transactions, similar enterprise structures are an ideal basis for comparison.

With respect to the structure currently employed by EGG and ESC and considering the fact that ESC merely resells EGG's finished products and does not control or own any significant intangibles with respect to the products, the resale price method could be acceptable.

In determining the margin to be deducted from the resale price, such margin is generally determined by applying the transactional net margin method (TNMM). This compares the net profit margin (in this case 1% of sales) arising from the alleged non-arm's length transaction with the net profit margins realised by unconnected parties from similar transactions; and examines the net profit margin relative to an appropriate base such as costs, sales or assets.

This differs from the cost-plus and resale price methods which compare gross profit margins. The net margins which are used in the TNMM are very sensitive to the relative cost structures of the entities being compared as they include operating expenses in their calculations. However, reliable information on gross margins may be difficult, if not impossible to obtain, which may imply that the TNMM may be the only practical method in many cases.

(d) Deductibility of royalty payment and potential SARS adjustments

The first issue of concern is whether the royalty payment by ESC would qualify for a tax deduction in South Africa. In this case, the royalty is a recurring payment (based on turnover), but is stated as being made to secure ESC's exclusive distribution rights in South Africa. The question which arises is whether the royalty payment is of a revenue or capital nature.

If revenue in nature, the royalty payment would be deductible and, if capital in nature, the royalty payment would not be deductible. Securing the exclusive distribution rights would seem to be expenditure to secure the 'income producing machinery' of the company and so may be challenged by SARS as being of a capital rather than a revenue nature. However, such a conclusion would depend on the exact terms of the agreement and would have to be analysed further.

If classified as capital, the royalty payment could be classified as a premium payable for the distribution rights. However, any deduction in respect of such a capital amount links to whether the receipt is 'income' in the hands of the recipient. In this case, the royalty withholding would apply to the payment resulting in the royalty being exempt from normal tax and therefore not being classified as 'income'. No deduction would seem to be applicable.

The second issue of concern for SARS is whether the prices charged for both the finished goods acquired from EGG and the royalty percentage charged are at arm's length. Should these be considered to be more than arm's length, an adjustment may be appropriate. A primary adjustment will be required to adjust the price which is effective for tax purposes to an arm's length price. A secondary adjustment will also be made in the form of a dividend *in specie* at the rate of 20% of the amount of the primary adjustment.

5 PropCo Ltd

(a) Sale of Portuguese property

In order to determine the tax implications arising from the sale of the Portuguese property, it must first be determined whether the property was sold with a capital or revenue intention. It is clear that the business of PropCo Ltd is to acquire properties with the intention of renting them out, in other words, the properties are acquired with a capital intention as productive assets. It is necessary to determine whether that intention changed when the property was disposed of. That the opportunity for making a profit on sale of the property may arise does not necessarily indicate a change of intention, but is merely realising the asset to the best advantage. The disposal of the Portuguese property also appears to be an isolated transaction relative to the other properties.

If it were found that PropCo Ltd's intention changed immediately before the sale, the change of intention from capital to revenue would trigger a capital gains tax event to transfer the property from capital stock to trading stock. The profit realised from the subsequent sale with a revenue intention would likely be minimal.

However, it is clear from the scenario that the sale decision was motivated by the lack of suitable tenants. In addition, the property was considered to be unsuitable for PropCo Ltd's existing property portfolio and there had been an increase in property prices, both of which added to the motivation to sell. It is therefore submitted that the original intention of capital is likely to remain valid at the point of sale. A capital gain on disposal of the Portuguese property to the third party will therefore arise.

The acquisition cost, sales proceeds and selling costs are all denominated in currencies other than South African rand. As a result, the transaction must be translated to rand. Specific translation rules apply in this regard.

The sales proceeds must be translated to rand at the average exchange rate for the year of assessment in which the property was disposed of or the spot rate on the date of disposal of the property, meaning that a choice exists for PropCo Ltd.

Second, the expenditure incurred in respect of the property must be translated to rand at the average exchange rate for the year of assessment during which that expenditure was incurred or the spot rate on the date on which that expenditure was incurred. Again, a choice (separate from the choice with respect to the proceeds) must be made by PropCo Ltd.

It is clearly advantageous for PropCo Ltd to elect the higher rate for the expenditure and the lower rate for the proceeds to limit the gain determined in rand. The Portuguese transfer costs are added to the base cost and the Portuguese capital gains tax incurred operate as a credit against the South African tax determined on taxable income (including this capital gain).

Supporting calculations:

	R
Proceeds (EUR 3,000,000 x 14·5965)	43,789,500
Less base cost:	
Acquisition cost (GBP 1,500,000 x 18·9169)	(28,375,350)
Selling costs (EUR 30,000 x 15·1246)	(453,738)
Capital gain	14,960,412

Assuming this is PropCo Ltd's only capital gain during the 2018 year of assessment and that the other activities of PropCo Ltd are profitable, then the South African tax on this capital gain would be R3,351,132 (R14,960,412 x 80% inclusion rate x 28% corporate tax rate).

A credit is available for the Portuguese tax incurred against this South African tax. The credit will be limited to the South African tax levied on the gain. The Portuguese tax must be translated at the average exchange rate for the 2018 year of assessment. This means that the Portuguese tax will be translated to R2,268,690 (EUR 150,000 x 15·1246). A full credit for this Portuguese tax would be available, reducing the South African tax liability to R1,082,442 (R3,351,132 – R2,268,690).

Value added tax (VAT) is not levied on this disposal as the property is located outside South Africa. Transfer duty is not leviable either, as this is also only applicable to properties in South Africa.

(b) (i) Amalgamation corporate rule

This proposed disposal of the three South African properties to SA Commercial Property Fund would be an 'amalgamation transaction'. This is because PropCo Ltd, a South African resident company, would be disposing of all of its assets to SA Commercial Property Fund, also a South African resident company, by means of an amalgamation and as a result of this transaction, PropCo Ltd will be terminated (within 36 months of the amalgamation transaction). The assets are being sold for shares in SA Commercial Property Fund.

The only assets which will not be transferred by PropCo Ltd are those assets which it elects to use to settle any debts incurred by it in the ordinary course of its trade and those required to satisfy any reasonably anticipated liabilities to any sphere of government of any country and costs of administration relating to the liquidation.

All of the assets being disposed of by PropCo Ltd are held as capital assets. A critical requirement for the application of the amalgamation rule is that SA Commercial Property Fund must acquire the properties as capital assets. As the nature of the two businesses is similar, it is likely that SA Commercial Property Fund will acquire the properties as assets of a capital nature, meaning that this requirement is met.

The proposed sale of all of PropCo Ltd's assets to SA Commercial Property Fund would therefore qualify for the relief offered by the corporate rule for amalgamation transactions.

(ii) Income tax relief available

PropCo Ltd would be deemed to dispose of the three properties to SA Commercial Property Fund at their respective base costs. This implies that the transaction would be tax neutral for PropCo Ltd as no capital gain or capital loss would arise.

Being commercial properties for rental, some of the properties may be considered 'allowance assets' being those assets on which capital allowances have been claimed. In this case, no allowance would be considered to be recovered or recouped by PropCo Ltd and the capital gains tax implications would remain the same (i.e. a disposal to SA Commercial Property Fund at base cost).

Second, while the nature of the tenants in these properties may have facilitated various building allowances for PropCo Ltd against the property cost, such as the manufacturing and commercial building capital allowances, these are not permissible for real estate investment trusts (REITs) to claim. In other words, SA Commercial Property Fund may no longer claim the deductions which had been claimed by PropCo Ltd. This does not mean that the transaction is prevented from continuing, but no further allowances would be claimable by SA Commercial Property Fund as a result of its status as a REIT.

Third, any distribution of the shares held by PropCo in SA Commercial Property Fund to its shareholders prior to the termination of its existence will be free of dividends tax.

			Available	*Maximum*
1	**(a)**	**Value added tax (VAT) registration obligations and compliance issues**		
		Identify that non-executive director earnings are taxable supplies	1	
		Identify that Lebo should be registered for VAT (director fees >R1,000,000)	1	
		Registration requirements	2	
		Method to apply for registration	1	
		Possible penalties for late registration/failure to submit/late payment	1½	
		Possible remittance of penalties	½	
			7	5
	(b)	**Tax benefits of retirement annuity funds**		
		Income tax relief	3	
		Investment returns not taxed in fund (contrasted with after-tax investments)	2	
		Lump sum tax-free on retirement	2	
		Annuity taxed	2	
		Limited inclusion of retirement annuity on death for estate duty purposes	2	
			11	9
	(c)	**Transfer of Property A to the trust**		
		By donation:		
		Identification and calculation of donations tax	1½	
		Identification and calculation of capital gains tax	2½	
		Identify the advantage for estate duty of the donation	1	
		By sale:		
		No donations tax if sale at full market value	1	
		Proportional donations tax consequences if sale at less than market value	1	
		Calculation of capital gains tax	1½	
		Implications if funded by bank loan (interest expense) and recognition defeats purpose of the trust	2	
		Use of capital on sale for retirement annuity and impact for estate duty	2	
		Implications if funded by interest-free loan from Lebo	2	
		Ongoing donation consequences of interest-free loan	2	
			16½	15
	(d)	**Income tax implications of income earned in the trust**		
		Identification of attribution consequences for future income	3	2
	Professional marks			
	Format and presentation of the report		1	
	Effectiveness of communication		3	
			4	4
				35

			Available	Maximum
2	(a)	**Value added tax (VAT) and customs duty implications of current distribution operations and potential VAT implications arising from release of mobile application**		
		Identify the duty on customer with respect to VAT/customs duty on imported goods	1	
		Identify no requirement for SupplyALL to register for VAT but may collect	1	
		Identify VAT will be determined by reference to added tax value	1	
		No VAT/customs duty on imports in transit	1	
		Identify no VAT consequences with respect to distribution warehouse employees or consultant	1	
		Supply of e-books will be an enterprise and reason	1	
		Requirement to register for VAT	1½	
		Identify representative vendor required	½	
			8	6
	(b)	**Risk of creating a permanent establishment (PE) in South Africa and consequences if SupplyALL were to set up a South African subsidiary**		
		Identify and explain the reasons for no PE	4	
		Income tax implications	1	
		Identify that VAT is unaffected by PE status	1	
		Subsidiary:		
		Identify that South African residence is triggered by incorporation	1	
		Identify risk of residence in Country A	1	
		Explain the consequence of the tie-breaker in a tax treaty	1	
		Identify that the tax implications unlikely to change significantly	1	
		Identify implications of increased presence in South Africa	1½	
		Identify that dividends tax would not apply for dividends declared to holding company	1	
			12½	10
	(c)	**Tax implications and compliance requirements with respect to the distribution service staff, visiting quality control expert and potential future employees/secondees**		
		Identify need for representative employer and requirements	2	
		Limitation for representative employer to only consider South African employees	1	
		Identify issue with respect to a PE and impact on SupplyALL employees tax withholding	2	
			5	4
	(d)	**Headquarter company regime criteria and suitable structure to make use of this regime**		
		Identify the conditions for a headquarter company	2	
		Application of the conditions to the supplied facts	2	
		Conclusion	1	
			5	5
				25

			Available	Maximum
3	**(a)**	**Sub A residence and controlled foreign company status**		
		Identify the manner in which residence in South Africa would be triggered	1	
		Explanation of the facts applied to place of effective management	3	
		Explanation of why not a controlled foreign company	2	
			6	5
	(b)	**Tax treatment of Joseph's Sub A salary and dividends and impact on retirement annuity fund contributions**		
		Identify participation exemption for the dividend	1	
		Identify the application of the foreign service exemption	1	
		Explanation as to the requirements for the foreign service exemption and application to the facts	2	
		Discussion of the permissible retirement annuity fund deduction and calculations	2	
			6	5
	(c)	**After-tax cash position if Joseph sells or does not sell his business**		
		Does not sell – income tax calculations	3	
		Does not sell – post-tax cash	1	
		Does sell – income tax calculation	3	
		Does sell – dividend received calculation (net of tax)	3	
		Does sell – post-tax cash	1	
		Conclusion	1	
			12	10
				20

			Available	Maximum
4	**(a)**	**Transfer pricing audit**		
		Actions taken (1 mark each)	4	
		South African Revenue Service (SARS) sends list of findings	1	
		Process if agreement not reached	1	
			6	5
	(b)	**Transfer pricing documentation**		
		Identification and explanation of key documentation	3	
		Identify the purpose of the documentation	2	
		Application of comparable data	1	
			6	5
	(c)	**Transfer pricing methods**		
		Identify that SARS provides no guidance as to preferred methods	1	
		Identify use of OECD transfer pricing guidelines	1	
		Considerations for identifying an appropriate method	2	
		Resale price method and explain	1½	
		Transactional net margin method and explain	1½	
			7	5
	(d)	**Deductibility of royalty payment and potential SARS adjustments**		
		Deductibility of royalty payment and explanation of capital v revenue and implications	4	
		SARS adjustments if price charged by EGG and royalty is not deemed to be at arm's length	2	
			6	5
				20

			Available	Maximum
5	**(a)**	**Sale of Portuguese property**		
		Identify capital versus revenue issue	1	
		Implications if revenue intention	1½	
		Arguments for capital intention with application to facts	3	
		Identify capital gains tax translation issues	½	
		Explanation of translation rules for sales proceeds and expenses	2	
		Identify advantage for the taxpayer	1	
		Calculation of capital gain	3	
		Calculation of South African (SA) tax	1	
		Calculation of foreign tax credit and effect on SA tax	2	
		Identify that VAT and transfer duty of no application	1	
			16	13
	(b)	**(i) Amalgamation corporate rule**		
		Explain the qualification under the rule	2½	
		Identify that assets must be received as used by disposer	1	
			3½	3
		(ii) Income tax relief		
		Explain the capital gains tax and allowance implications for PropCo Ltd	2	
		Identify issue for REIT of allowances on immovable property	2	
		No dividends tax on distribution of SA Commerical Fund shares held by PropCo to its shareholders	½	
			4½	4
				20