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 Expand (Pty) Ltd

Report

To: The directors (Expand (Pty) Ltd)
From: ACCA Candidate
Date: 4 June 2019
Subject: Taxation queries

Taxation queries received

With reference to our previous correspondence and discussions, I have drafted this report to address each of your queries with respect to the business of Expand (Pty) Ltd (Expand) and the taxation implications of several transactions. For ease of reference, my answers are stratified into sub-headings.

Issue 1 – Conversion of debt to equity in respect of Co A

Expand's current equity stake represents a 10% holding in Co A. The addition of 2,100 shares to settle the loan finance would increase Expand's shareholding to 18·6% ((2,100 (new) + 2,000 (existing))/((2,000/10%) + 2,100)). This determination is relevant as this shareholding would be insufficient to classify Co A as being 'connected' to Expand for income tax purposes. This transaction would therefore be considered to be between third parties. Furthermore, it is clear that Co A and Expand do not and would not form part of the same 'group of companies' as defined.

The debt will be converted to equity shares. Such a conversion would be considered a 'concession or compromise' for Income Tax Act purposes. It must therefore be determined whether or not a 'debt benefit' arises for Co A. A debt benefit in this context is the extent to which the face value of the debt (R300,000) exceeds the difference between the market value of the total shareholding immediately after the conversion of the debt and the market value of the shareholding immediately prior to the conversion of the debt. Based on your supplied information, the market value of the existing shares is R100 per share (R200,000/2,000). The market value of each share after the proposed conversion is projected to be R80 per share. Based on these provisional figures (which may change based on the actual date of the transaction), it follows that a debt benefit of R172,000 (R300,000 – (R328,000 – R200,000)) would arise, being the debt of R300,000 reduced by the difference between the new market value of shares held (R80 x 4,100) and the market value of the shares before conversion (R100 x 2,000).

The debt benefit has varying consequences. For Expand, a capital loss arises as the 'disposal' of the loan for equity shares of a lesser value represents a loss to Expand. As the parties are unconnected, the capital loss may be recognised. As Expand may utilise the capital loss, the debt benefit which arises should be recognised as a form of increase in taxable income (whether immediate or deferred) in the hands of the benefiting party (in this case Co A).

For Co A, the consequences are split into two scenarios as the manner in which the money was used determines the manner in which the debt benefit is to be recognised. For the portion of the finance used to acquire trading stock, two consequences emerge:

(i) For the portion pertaining to trading stock still on hand, the recorded stock value must be reduced by this value (i.e. 5% x 50% (as half the money was used for trading stock) x R172,000 = R4,300). This 'reduction' to the cost of the trading stock has an impact both on the value claimed as a deduction and the balance of closing stock.

(ii) The balance used to acquire trading stock already sold will be recognised as a recoupment (i.e. 95% x 50% x R172,000 = R81,700). This will be to offset the higher deduction previously claimed on the acquisition of the trading stock.

For the portion used to acquire the machine, an allowance asset, the debt benefit, i.e. R86,000 (R172,000 x 50%), is first recognised as a recoupment on allowances previously claimed. In this case for a new manufacturing asset, Co A would have claimed 60% (40% in year 1 and 20% in year 2) of the R150,000 expenditure. This equates to allowances of R90,000, rendering the entire debt benefit in relation to the machine to be recognised as a recoupment. The expenditure for base cost purposes will also be reduced to reflect the actual cost (i.e. R150,000 – R86,000 = R64,000). This new 'expenditure' will also reflect the full value of possible allowances remaining (40% x R150,000 = R60,000 plus R4,000 (R90,000 claimed less R86,000 recovered)).

Issue 2 – Interest on loans to Kenyan companies

With respect to the loans to Kenyan companies in which Expand holds equity shares, you have specifically requested information on transfer pricing risks and the implications if transfer pricing adjustments are necessary.

It is first important to consider whether the Kenyan companies and Expand are connected persons or not for the purposes of the Income Tax Act. Transfer pricing adjustments are only currently necessary where:

(i) a tax benefit arises;
(ii) as a result of transaction between connected persons; and
(iii) the transaction is essentially between a resident and a non-resident.

With respect to whether a tax benefit arises, it is important to recognise that the benefit may arise in either party's hands. A tax benefit is any avoidance, postponement or reduction of any liability for tax (with tax being any tax or penalty imposed in terms of the Income Tax Act). While a benefit certainly arises in that the Kenyan companies will be deducting an interest expense higher than market rates and that since the Kenyan corporate tax rate is higher than that of South Africa, the benefit is enhanced, it does not impact tax levied in South Africa. Expand, as the recipient of the interest, does not avoid, reduce or postpone the liability for tax. Rather the tax liability is higher as a result of receiving interest at a higher rate. On this requirement alone, there appears to be no need to make any adjustment for income tax purposes in South Africa.

The financing transactions do, however, take place between connected persons. Generally speaking, Expand will be considered to be connected with any company in which it has a controlling holding or an investment in equity share capital of between 20–49% where no other shareholder holds a greater single holding.

It is further clear that the transactions take place between a South African resident (Expand) and non-residents (the Kenyan companies).

In conclusion, while the conditions of connected persons where one is resident and one is non-resident are met, there does not appear to be a tax benefit which arises in South Africa requiring the application of the transfer pricing adjustment. Note, however, that should Kenya process an adjustment, a similar adjustment may need to be processed in South Africa in terms of the double tax treaty (decreasing the taxable income in South Africa and increasing the taxable income in Kenya resulting in an overall higher tax burden across the two parties).

Even if the conditions for a transfer pricing adjustment are met, further limitations to the application may apply if a Kenyan company is a controlled foreign company in relation to Expand. Such implications would only come to pass if another resident shareholder caused the total holding by South African residents to exceed the 50% threshold. In such instances, especially as these Kenyan companies are likely to be considered foreign business establishments, the controlled foreign company (CFC) rules take precedence and the transfer pricing rule does not apply. The adjustments would rather occur in the determination of the profit to be attributed in terms of the CFC rules.

Issue 3 – Foreign exchange issues on borrowings from Uitbreiden NL

A clear foreign exchange difference will arise on the translation of the debt at year end. The devaluation of the Rand will have raised the amount owed, generating a foreign exchange loss from a South African perspective of R1,700,000 (EUR 1,000,000 x (17·20 – 15·50)).

The hedge contract would provide rate certainty, but it depends on the long-term view of the Rand against the Euro as to whether this quoted rate will be beneficial. By way of example:

(i) Assume the EUR–ZAR rate remains at R17·20 to the EUR and the hedge contract was taken on 100% of the loan capital. No further loss arises on the loan capital itself (EUR 1,000,000 x (17·20 – 17·20)), but the hedge contract will generate a loss of R300,000 (being EUR 1,000,000 x (17·50 – 17·20)).

(ii) Assume the EUR–ZAR rate moves to R18·00 to the EUR and the hedge contract was taken on 100% of the loan capital. While the loan capital is subject to further losses of R800,000 (being EUR 1,000,000 x (18·00 – 17·20)), the hedge taken at R17·50 will offset that loss with a R500,000 gain (being EUR 1,000,000 x (18·00 – 17·50)).

(iii) Assume the Rand strengthens to R16 to the EUR and the hedge contract was taken on 100% of the loan capital. In this scenario, the loan capital loss initially incurred is partially reversed with a gain of R1,200,000 (being EUR 1,000,000 x (17·20 – 16·00)) whereas the hedge contract more than erodes this gain with a loss on the hedge of R1,500,000 (being EUR 1,000,000 x (17·50 – 16·00)).

In summary, should the Rand strengthen, the hedge will create a loss which will erode the reversal of the currently recognised exchange loss. However, if the Rand depreciates further, the hedge gain will offset any further exchange loss beyond the quoted hedge rate if the full value of the loan is hedged. All of these exchange differences will be claimed for income tax purposes with gains adding to taxable income and losses reducing taxable income.

The interest on the loan will remain susceptible to currency fluctuations and generate foreign exchange gains and losses between the date on which the interest is incurred and the date of payment of such interest. Similarly, the exchange losses are deductible and the gains taxable.

Issue 4 – Implications of electing to become a headquarter company

(a) Potential tax benefits arising from an election to become a headquarter company

Numerous South African tax benefits arise from a classification as a headquarter company. These include the following:

- Dividends received by Expand from its investments in South Africa and within Africa (in which it holds at least 10%) will be exempt from income tax in South Africa. As all of the investments held by Expand meet this requirement, the dividend income would be exempt.
- The dividends paid by Expand to Uitbreiden NL will not be subject to dividend withholding tax.
- The interest payable by Expand to Uitbreiden NL as its sole shareholder will not be subject to interest withholding tax (as the interest is being paid to a shareholder).

- When Expand disposes of its foreign investment holdings in Africa (where the equity shareholding is at least 10%), no capital gains tax is payable.
- The South African transfer pricing rules are relaxed considerably with respect to Expand and the foreign entities into which it invests. In most cases, the transfer pricing rules will not apply, facilitating greater opportunity to lend at non-arm's length rates.
- The controlled foreign company rules (where Expand's holdings together with other residents are sufficient to meet the qualification criteria) are not applicable.
- Exchange control restrictions will not apply to the outbound investments made by Expand.

However, the difficulty lies not in the benefits which may be applied to a headquarter company, but rather the tax implications of making the election to be treated as a headquarter company.

(b) The immediate income tax implications should an election be made to become a headquarter company

- The key considerations pertain mainly to the exit tax to be levied on becoming a headquarter company. On becoming a headquarter company, Expand would be deemed to have sold all of its assets to a resident immediately before becoming a headquarter company (and deemed to have immediately reacquired them – i.e. creating a stepped up base cost for the headquarter company). This renders the company subject to an immediate and large capital gains tax liability requiring liquidity to settle.
- Expand would also be deemed to have declared a dividend *in specie* immediately before becoming a headquarter company equal to the difference between the market value of its shares and the contributed tax capital (effectively declaring all reserves as a deemed dividend). This renders all reserves subject to an effective 20% withholding tax for which, as a dividend *in specie*, the company will be liable. Again, this is a significant liquidity issue and risk.
- Further complications will arise if any of the investments held by Expand are controlled foreign companies.

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

2 Wim Burgers

(a) South African tax residence position under the physical presence test

As Wim has just entered South Africa (even if the entire year has been spent in South Africa), he is unlikely to be considered as a resident of South Africa in terms of the physical presence test. In terms of that test, Wim would have to be in South Africa for 91 days each year for the past five years of assessment, in aggregate 915 days over the five preceding years and even then would have to be in South Africa for more than 91 days in the sixth year of assessment. While the counting of days in South Africa would have started in respect of Wim and his employment contract, he does not meet the requirements for the physical presence test.

However, Wim should be mindful that if the contract extension is accepted, then he may become a resident of South Africa for income tax purposes as he is likely to meet the objective requirements in the first year of the extension period.

(b) Tax implications arising in respect of employer retirement fund contributions and the employee share scheme under Options A and B

As regards the contributions to the Netherlands pension fund, the amount contributed by Cosmic (Pty) Ltd is unlikely to qualify as a fringe benefit as the fund is not registered in South Africa. As there is no fringe benefit (and as there appears to only be contributions from the employer), there is no deduction available against Wim's cash salary for contributions to a retirement fund.

Before the mechanics of the share scheme may be considered, it is first important to establish whether any taxing right exists with respect to the shares. The participation in the share scheme, in which the shares in Global Holding Company (GHC), the Netherlands-based holding company, are awarded to employees globally arises directly from the employer–employee relationship. It is the work performed by the employees which entitles them to participate in the scheme. From a South African source perspective, the shares awarded represent South African source, arising as a result of employment.

As such, any revenue inclusion from the employment must be included in the taxable income of Wim. Once the shares have vested and become the property of Wim (without restriction), then the implications of Wim being a non-resident come to the fore. As a non-resident holding foreign shares, the disposal of those shares will not attract capital gains tax in South Africa. Non-residents are only subject to capital gains tax on immovable property (or interests in immovable property) in South Africa and assets of a permanent establishment. It is submitted that Wim's employment does not create a permanent establishment and further that the shares would not be connected to the import and export business (should that create a permanent establishment in South Africa).

What remains to be determined is the extent to which any gain on the shares until they vest will be taxed in South Africa.

In terms of Option A, the shares acquired bear no restriction on disposal. The purchase price may be financed via an employee share trust set up for this purpose. Despite the loan finance coming from an associated entity (the employee share trust), the

fact that the shares are unrestricted means that they immediately vest in the hands of the employee. The 5% benefit which the employee immediately receives on acquisition (being the ability to acquire the shares at a 5% discount on the market price) represents a gain arising from employment and is therefore subject to normal income tax in South Africa (effectively as employment income) for Wim where arising from his South African employment period. As detailed above, Wim's subsequent disposal of those shares will have no bearing on his South African tax base.

Option B places a restriction on the disposal of the shares. The scheme provides a discount of 10% on the market value of the shares of the company, but disposal may not take place until one full year has passed since acquisition. This restriction means that any possible gain is indeterminable until such time as the restriction is lifted. Only on vesting of the shares is the gain or loss received by the employee determined. Any gain or loss is considered to be directly related to the employment. The gain, denominated in foreign currency, would have to be translated to Rands, generally at the spot rate on the date of vesting. If linked to Wim's time in South Africa as an employee, any gain would be taxable or loss deductible. Again, any disposal after the vesting date (one year after acquisition) would not impact the South African tax base as long as Wim is a non-resident.

The dividends received on the GHC shares are foreign dividends received by a non-resident and therefore carry no South African income tax consequences (being from a foreign source). Similarly, the investment of those dividends in units tracking the share price of GHC would also have no source in South Africa and would remain untaxed in South Africa for as long as Wim is a non-resident.

(c) South African value added tax (VAT) and income tax implications of Wim's import and export business

It is clear that Wim will be conducting an enterprise in South Africa, namely the sales of Dutch edible treats to South African retailers. It is further evident from the scenario that he has promised sales in excess of R1,000,000. The sales of edible treats represent the sale of a good for VAT purposes. It is unlikely that the goods to be sold to the South African retailers would represent either exempt or zero rated supplies.

For the above reasons, Wim would meet the requirements for compulsory registration for VAT purposes. From the commencement of the month in which the contracts are projected to be in excess of R1,000,000 for the coming 12 months, he becomes liable for registration as a VAT vendor. Such requirement to register requires the application to be submitted to the South African Revenue Service (SARS) within 21 working days from the start of the obligation. Complicating the issue is the fact that Wim is a non-resident. The application for VAT registration will therefore be deemed to be incomplete until Wim appoints a representative vendor (and declares the details of this representative vendor to SARS) and further opens a bank account in South Africa for the purpose of the enterprise (with the details of this bank account being supplied to SARS).

The future export of South African goods to other countries will be zero rated (permitting the claim of input taxes leading up to the export of those goods). The import of the foodstuffs from the Netherlands will lead to VAT being payable by the importer (but also claimable as input VAT on release from customs).

From an income tax perspective, Wim is a sole trader and therefore must declare the profit from the sale of the Dutch treats in his tax return. However, as Wim is a non-resident, only those profits whose source is in South Africa qualify to be included in the South African tax return in terms of domestic law. Such consideration would have to be considered also in light of the tax treaty with the Netherlands which would only grant the taxing right to South Africa with respect to these business profits if a permanent establishment is found to exist. Exchange differences arising from the ordering and payment for the Dutch goods will be recognised in South Africa as they will attach to Wim's business, being a permanent establishment.

(d) VAT implications with respect to pre-registration purchases

It may be possible for Wim to claim a 'change in use' adjustment with respect to the goods acquired and held at the time he becomes registered for VAT. Essentially, while Wim is a non-vendor, none of the activities are necessarily considered to be the making of taxable supplies. However, on VAT registration, the export and local sale of the treats acquired will be the making of taxable supplies (albeit that the exports are zero rated) and so he may be able to claim the input tax on the pre-registration purchases.

The change in use adjustment requires that the amount of the adjustment is calculated by applying the tax fraction (15/115) to the lesser of the adjusted cost (being the cost to Wim if he had been a vendor at the time of acquisition) (including VAT), or the open market value of the relevant goods or services. The change of use to be claimed on the local purchases would therefore be R26,087 (R200,000 x 15/115).

For the imported goods, the value on which VAT is raised is the added tax value (ATV) which is equal to the customs value plus any customs duty plus 10% of the customs value. 15% is calculated on the ATV to determine the VAT to be paid by the importer. Wim would have paid R62,250 ((R350,000 + R30,000 + 10% x R350,000) x 15%). It is submitted that this amount would be claimable as the change in use adjustment in respect of the imported goods.

3 Reginald Rich

(a) Income tax implications for Reginald in respect of the interest-free loans to the trust for Prop A and Prop B for the 2019 year of assessment

The interest-free loan account may be considered two loans (one for each property). The first loan is in respect of Prop A, Reginald and Doris's primary residence. Provided the conditions below are met, this loan will not attract notional interest deemed to be a donation from Reginald to the trust as the interest-free loan provider.

For the loan on Prop A to be excluded:

(i) The trust must have used the loan to acquire an asset (i.e. Prop A, the primary residence);

(ii) The person who supplied the loan (Reginald) or his spouse (Doris) must have used the property as their primary residence throughout the year of assessment in which the trust held the property; and

(iii) The loan must relate to the primary residence.

The second property (Prop B) will attract a notional interest attribution. The notional interest deemed to be a donation made by Reginald to the trust for the year of assessment 2019 would be R1,600,000 (R20,000,000 x 8%), being the excess of the official rate less the low/no interest charged.

This deemed donation is subject to donations tax. Assuming Reginald made no other taxable donations during the year, the annual donation exemption for natural persons of R100,000 will apply, rendering Reginald liable for donations tax of R300,000 ((R1,600,000 – R100,000) x 20%).

In addition, any income retained by the trust and not distributed to the other beneficiaries will be attributed to Reginald for as long as the loan on Prop B remains unpaid (as Prop A earns no income).

Tutorial note: *The deemed donation provision is only determined at the end of the year of assessment of the trust.*

(b) Income tax implications for Reginald and the trust in respect of Prop B for the 2020 year of assessment

The trust will receive profit from the rental of Prop B, being R720,000 (R100,000 x 12 – R40,000 x 12). The interest of R214,500 on the bank loan over Prop B to repay the loan from Reginald may be permitted as a deduction if it is considered to be incurred in the production of income (i.e. the rental income). The trust may be able to argue that repayment of the interest-free loans necessitated refinancing for the same asset (otherwise the repayment would have forced a sale). In such circumstances, it is more likely that the deduction would be permitted. This would leave a net profit in the trust of R505,500 (R720,000 – R214,500).

Unless the income (including the related expenditure) is vested in beneficiaries, most of the remaining profit in the trust will be attributed to Reginald. As the trust will have third party funding for the asset, the attribution to Reginald of any remaining net profit (assuming none was distributed) would be in the ratio of lending, i.e. remaining loan from Reginald/total loan finance at the end of the year. In this case (assuming a full year of the bank loan), the ratio would be: R15,700,000 (being R20,000,000 original loan less R4,300,000 financed from the bank)/R19,977,700 (being R15,700,000 from above plus R4,300,000 less R236,800 repayments plus interest charged R214,500).

The trust, assuming no income is distributed, will be responsible for 45% tax on R108,240 (being R505,500 x 4,277,700/19,977,700).

The deemed donation based on notional interest would still arise for Prop B (Prop A will have been sold by the trust). The deemed donation is determined at the end of the trust's year of assessment. However, from 1 November 2019, Reginald would be a non-resident to whom donations tax does not apply. It is unclear whether there would be any implication on Reginald's exit as a resident of South Africa. The anti-avoidance provisions for these interest-free loans should therefore have little impact once Reginald is non-resident.

On ceasing to be a resident, the balance of the loan account on Prop B would be deemed to have been disposed of by Reginald before ceasing to be a resident. This, however, has no real impact as the base cost of the loan would match the deemed proceeds in most cases.

(c) Best way for Reginald and Doris to structure their export of capital to fund the Cyprus purchase prior to ceasing to be resident on 1 November 2019

Reginald and Doris need EUR 2,100,000 available for the Cyprus property purchase and associated costs. Assuming that the amount to cover the capital gains tax on the sale of the foreign investments is not remitted back to South Africa, Reginald and Doris would still need to export a further EUR 1,100,000 (EUR 2,100,000 – EUR 1,000,000) of capital. This would convert (at the date the capital is exported) to R17,600,000 (EUR 1,100,000 x 16).

Based on the South African Reserve Bank restriction to only export up to R10 million per person per annum for investment, the capital to be exported must be split between Reginald and Doris. Two options must be considered to achieve this split of capital:

(1) The foreign and local investments are sold by Reginald and the proceeds (after tax) are split between the spouses to remit overseas in compliance with the exchange control regulations. It should be noted that no capital gains tax arises on the subsequent donation of cash to Doris by Reginald, as the cash is not considered an asset. Further, no donations tax would

arise as the donation would take place between two resident non-separated spouses. However, Reginald is subject to tax at the maximum marginal rate on the disposals (eroding the capital).

(2) Some of the foreign and local investments could be donated by Reginald to Doris prior to sale. The proceeds (after tax) should be greater as Doris could make full use of the progressive tax tables and another annual exclusion for natural persons. However, this option presents a number of risks discounting this option:

(i) Inconsequentially, Doris would have to register as a provisional taxpayer to facilitate the capital gains.

(ii) Significantly, the Commissioner for the South African Revenue Service (SARS) may invoke an anti-avoidance provision deeming the capital gain to be Reginald's where the donation to Doris was purely to avoid a tax liability (in this case, income tax). The risk is high in this instance as the only motivation can be the reduction of tax and this option is therefore dismissed.

Option 1 above

While the loan repayments totalling R18,300,000 from the trust (being the R14,000,000 from Prop A's loan repayment and R4,300,000 from Prop B's loan repayment) would initially appear sufficient to cover the capital to be exported, Reginald will first have to account for the potential South African capital gains tax liability arising from the sale of the foreign investments. The capital gains tax would amount to R829,800 (see Appendix A).

This would reduce the amount available to be transferred to R17,470,200 (R18,300,000 – R829,800), meaning Reginald would have to dispose of the South African investments. This disposal will attract additional capital gains tax of R45,000 (being R874,800 (see Appendix B) – R829,800 (Appendix A)). This would provide Reginald and Doris capital of R18,175,200 (R18,300,000 + R750,000 (the proceeds on sale of local investments) – R874,800 (the capital gains tax)).

Alternatively, Reginald could have asked the trust to repay more of the loan on Prop B and retain the South African investments, but he would have still had to fund the deemed disposal of the South African investments on ceasing to be a resident.

Appendix A – Sale of foreign investments only

	EUR	R
Proceeds	1,000,000	
Less base cost	(700,000)	
Capital gain	300,000	
Capital gain translated to Rands at EUR 1 = R15·5		4,650,000
Less annual exclusion		(40,000)
Net capital gain		4,610,000
Inclusion in taxable income (40%)		1,844,000
Tax payable (45%)		829,800

Appendix B – Sale of foreign and local investments

	R	R
Capital gain on foreign investments (above)		4,650,000
Proceeds on sale of local investments	750,000	
Less base cost	(500,000)	
Capital gain	250,000	250,000
		4,900,000
Less annual exclusion		(40,000)
Net capital gain		4,860,000
Inclusion in taxable income (40%)		1,944,000
Tax payable (45%)		874,800

4 Nigil Job

(a) Income tax consequences of the severance benefit receipt and the lump sum withdrawn from Nigil's company pension fund accumulation account

Each lump sum must be examined in turn, even though the effects are cumulative. In the first instance, the severance benefit is taxed by reference to the table applicable to retirement lump sums. As this lump sum was payable as a result of the termination of Nigil's employment due to a company restructure, this amount is taxed as a retirement benefit. This means that the tax levied is R117,000 ((R1,000,000 – R700,000) x 27% + R36,000)). The first R500,000 is effectively tax free. The net cash received by Nigil in respect of this lump sum is R883,000 (R1,000,000 – R117,000).

The second lump sum is not considered a retirement lump sum as Nigil had not reached 'normal retirement age' as defined in the company pension fund rules. The result is that the lump sum is taxed by reference to the withdrawal tables and not the retirement tables. The balance, transferred to the retirement annuity fund (RAF), is free from taxation at this stage – i.e. the transfer defers taxation. The tax on this lump sum, however, remains cumulative with any retirement lump sum already taken. This means that the tax on the R550,000 withdrawn from the company pension fund would amount to:

		R
Cumulative lump sums (R1,000,000 + R550,000)		1,550,000
Tax on cumulative total	(R1,550,000 – R990,000) x 36% + R203,400	405,000
Less tax on previous lump sum calculated by reference to the withdrawal table	(R1,000,000 – R990,000) x 36% + R203,400	(207,000)
Tax on R550,000 lump sum		198,000

This is an effective rate of 36% on this lump sum. Nigil would have received after-tax cash of R352,000 (R550,000 – R198,000) from this lump sum.

(b) Post-retirement medical benefit and subsequent impact on medical aid rebates

At the point that Nigil is provided with the post-retirement medical contribution subsidy, he is no longer an employee of Great Ltd. This means that the payment of the subsidy cannot be considered a fringe benefit for an employee and is therefore unlikely to be taxed in Nigil's hands.

However, a further implication of the above subsidy is that the amount will not be considered to be incurred by Nigil for the purpose of determining any additional medical expenses credit.

(c) Income tax implications of the amounts received by the executor of Nigil's estate in respect of the partnership and the tax implications of the life policy held by the other partners over Nigil's life

The profit share received from the partnership must be included in Nigil's last tax return to the date of death (as an amount which accrued while he was alive). However, certain adjustments are necessary. First, Nigil cannot claim his share of the bad debt which has been set off against the partnership profits as a deduction for income tax purposes. The bad debt is only permitted as a deduction where the income was previously included in the income of the taxpayer. As this debt relates to income earned by the other partners before Nigil joined the partnership, he cannot participate in the deduction. An add back for income tax purposes of R200,000 (20% x R1,000,000) reflecting Nigil's share of the debt written off arises. Second, while the interest on the partner's capital accounts represents a reduction of partnership profit, Nigil's own interest cannot be a deduction in his hands. Therefore, Nigil's interest earned on the capital account must be added back to his taxable income being R25,000 (5% x R1,500,000 x 4/12 months).

The capital repayment arises as a result of Nigil's death. The repayment is effectively a disposal of the partnership after death. The executor will disclose the partnership interest as an asset for deemed disposal purposes for capital gains tax in Nigil's last tax return. With respect to Nigil's last tax return, the calculation for capital gains tax would be impacted by the amounts included in income (i.e. the partnership profit as adjusted by the expenses in the partnership not permitted for Nigil's tax purposes). It follows that a potential loss arises in this case in respect of the partnership capital returned (much like a liquidation distribution proceeds is reduced by that portion which is a dividend).

While the proceeds from life policies usually are property of the deceased for estate duty purposes, even when not taken out by the deceased, an exception exists with respect to a partnership where the partners have taken out the policy specifically to acquire the deceased's partnership interest in the event of their death, such that such interest is shared between those partners who insured the life. The policy in question appears to meet these requirements and so no inclusion for estate duty will arise in respect of that policy.

	Available	Maximum
1 Expand (Pty) Ltd (Expand)		
Issue 1 – Conversion of debt to equity in respect of Co A		
Determination of revised percentage holding after debt conversion	1	
Explanation of implications of increased holding – no qualification as connected persons	1	
Identification that companies do not form part of a group of companies	1	
Identification of conversion as possibly generating a debt benefit	1	
Description of debt benefit concept in context	1	
Calculation of projected debt benefit	1	
Explanation of implications for Expand as being a capital loss	1	
Explanation for trading stock component of the debt benefit with respect to stock on hand	1	
Explanation for trading stock component of the debt benefit with respect to stock already sold	1	
Explanation for capital asset component of the debt benefit and the reduction of base cost	1	
Calculations of recoupment and reductions	2	
	12	10
Issue 2 – Interest on loans to Kenyan companies		
Identification of three essential conditions for a transfer pricing (TP) adjustment	1½	
Explanation of meaning of tax benefit	1	
Application of meaning of tax benefit to the facts	1	
Conclusion that no tax benefit arises in South Africa	½	
Explanation of definition of connected persons based on the facts	1	
Identification that parties need to include both residents and non-residents	1	
Identification of possibility that a TP adjustment may arise through the application of the tax treaty	1	
Identification that controlled foreign company (CFC) status may limit the application of the TP rules	1	
Identification that TP adjustment would take place, for a CFC, within the 'net income' determination and not in terms of the usual TP rules	1	
	9	8
Issue 3 – Foreign exchange issues on borrowings from Uitbreiden NL		
Identification of foreign exchange difference at year end	1	
Calculation of impact of foreign exchange difference	1	
Explanation of operation of the hedge contract	2	
Explanation of interest implications	1	
Tax implications of exchange gains and losses explained	1	
	6	4
Issue 4 – Implications of electing to become a headquarter company		
(a) Tax benefits of electing to become a headquarter company		
Identification of benefits of becoming headquarter company (1 mark per benefit linked to the scenario)	7	
(b) Immediate income tax implications of electing to become headquarter company		
Identification of exit tax implications	1	
Identification of dividend *in specie*	1	
Identification of additional CFC concerns	1	
	10	9
Professional marks		
Format and presentation of the report	1	
Effectiveness of communication	3	
	4	4
		35

		Available	*Maximum*
2	Wim Burgers		
(a)	**South African tax residence position under physical presence test**		
	Application of physical presence test	2	
	Consideration of contract extension on residence	1	
		3	2
(b)	**Tax implications of retirement fund contributions and employee share scheme options**		
	Identification that contributions to foreign retirement fund will not be a fringe benefit	1	
	Identification that no deduction will result from the foreign pension fund contributions	1	
	Identification of taxing rights	1	
	Application of South African source rule for employment	1	
	Identification of effect of gain on vesting arising from employment	1	
	Identification of effect of disposal post vesting	1	
	Exclusion of link to permanent establishment	1	
	Application to Option A	2	
	Application to Option B	2	
	Identification of implications for dividends received from these shares	1	
	Tax implication arising from additional units	1	
		13	11
(c)	**South African value added tax (VAT) and income tax implications of import and export business**		
	Identification that goods are VATable and taxable supplies	1	
	Identification of need to register as a vendor	½	
	Identification of timing of duty to register and time frame	1	
	Explanation of need for a representative vendor and South African bank account for the enterprise (and the implication for registering for VAT)	1½	
	Identification of tax effects of imports and exports	1	
	Identification of domestic income tax law for business profits	1	
	Identification of possible exchange differences for the goods to be recognised in the permanent establishment	1	
	Identification of treaty consideration for the right to tax	1	
		8	8
(d)	**VAT implications with respect to pre-registration purchases**		
	Identification of change in use to claim the input tax	1	
	Explanation of change in use	1	
	Explanation and calculation for local supplies	2	
	Explanation and calculation for imported supplies	2	
		6	4
			25

		Available	Maximum
3	**Reginald Rich**		
(a)	**Income tax implications for Reginald in respect of interest-free loans to trust for Prop A and Prop B for 2019 year of assessment**		
	Identification that two loans exist	½	
	Identification that loans may attract a deemed donation	½	
	Identification of conditions to exclude the Prop A loan from deemed donation	1½	
	Calculation of notional interest which becomes a deemed donation in respect of Prop B	1	
	Calculation of donations tax levied on Reginald	1	
	Identification of attribution rule for residue income while the loans remain unpaid	1	
		5½	4
(b)	**Income tax implications for Reginald and trust in respect of Prop B for 2020 year of assessment**		
	Identification that rental income earned by trust is taxable income (with calculation)	1	
	Identification that interest on loan secured against Prop B may be deductible against such income if it is in the production of income	1	
	Calculation of net profit in trust	½	
	Explanation that, unless income is distributed, income would mainly be attributed to Reginald	1	
	Calculation of attribution ratio	1	
	Implications for trust (with calculation)	1	
	Identification that while deemed donations would still arise, no donations tax may be levied as this tax is only raised on residents	1	
	Identification of deemed disposal of outstanding loan accounts, but is of limited impact	1	
		7½	6
(c)	**Best way for Reginald and Doris to structure export of capital to fund Cyprus purchase prior to ceasing to be resident on 1 November 2019**		
	Identification and calculation of capital export needs	1	
	Identification of need to split capital between spouses	1	
	Explanation of how transfer can take place within Reserve Bank limits (1 mark per option)	2	
	Explanation of why mitigation technique of donation to Doris will not work	1	
	Identification that loan repayment is insufficient to fulfil capital needs after capital gains tax on foreign investments	1	
	Calculation of capital gains tax on disposal of foreign investments	2½	
	Calculation of impact of additional disposal of South African investments	2½	
	Calculation of overall capital remaining	1	
		12	10
			20

4 Nigil Job

	Available	Maximum
(a) Income tax consequences of severance benefit receipt and lump sum withdrawn from Nigil's company pension fund accumulation account		
Identification that each lump sum, while separate, has cumulative impact	1	
Identification of severance benefit as a 'retirement' benefit and condition to be met to qualify	1	
Calculation of tax on severance benefit and net cash received	2	
Identification that second lump sum is classified as a withdrawal in terms of fund rules	1	
Identification of need to use withdrawal tables	1	
Identification that transfer of balance to retirement annuity fund (RAF) is tax free (effectively deferred)	1	
Calculation of tax on lump sum from pension fund	2	
	9	9
(b) Post-retirement medical benefit and subsequent impact on medical aid rebates		
Identification Nigil not an employee therefore no fringe benefit	1	
Explain run on consequence of such classification	1	
	2	2
(c) Income tax implications of amounts received by executor in respect of partnership and tax implications of life policy held by other partners over Nigil's life		
Identification that profits accrue to Nigil for inclusion in final tax return	1	
Identification that supplied profits from partnership require adjustment	1	
Discussion of implication of bad debt on inclusion in Nigil's taxable income	2	
Supporting calculation	1	
Discussion of implications of interest on partnership capital	1	
Supporting calculation	1	
Identification that partnership interest is an asset subject to deemed disposal on death	1	
Explanation of how adjustments from earlier impact proceeds for capital gains tax calculation	1	
Discussion of implications of life policy taken out by other partners to acquire partnership interest	1	
	10	9
		20