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: The Directors, Elegance Ltd
From: Tax Adviser
Date: 8 December 2020
Re: Report on planned South African operations

With reference to your email request received, please find below the information pertaining to your queries. We have limited our scope to those issues as specifically requested.

For your convenience and direct reference, the report has been stratified into sub-headings.

(a) Query 1: General tax overview
This section of the report focuses on the implications in terms of income tax (including relevant withholding taxes under the Act) and value added tax (VAT). It is noted, first, that SubCo is incorporated in South Africa, making it resident for South African tax purposes. As there is no treaty between South Africa and Chocoland, no residence in terms of any treaty alters this understanding.

Corporate income tax will be levied on the profits earned by SubCo. The tax is a flat rate of 28% to be levied on the taxable income as determined. Based on the initial capital costs, it is anticipated that SubCo will incur a substantial assessed loss for the first few years (as a result of accelerated allowances received and charges payable to Elegance Ltd). Any assessed loss will be carried forward and will be available for set off against future profits.

The anticipated turnover level of R50,000,000 suggests that SubCo would be required to register for South African VAT. SubCo would be the registered VAT vendor and the entity's public officer would be the representative vendor.

It is further suggested that VAT registration be completed prior to engaging in further transactions as the registration would be useful for the importation of the machinery (and later the cocoa beans).

The employment of the factory staff and the payment of staff seconded to the South African operations will require employees tax to be withheld from the remuneration paid. SubCo will have to withhold employees tax on all remuneration paid to its employees. As Elegance Ltd continues to pay the seconded employees (i.e. the cost of employment is not borne by SubCo), it will have to appoint a representative taxpayer to withhold the employees tax and submit the returns to the South African Revenue Service (SARS). It would be logical to appoint the public officer of SubCo (already the representative taxpayer for the entity) as the representative taxpayer for Elegance Ltd in this regard. Note that the recharge of the amounts payable to the seconded employees as incurred by SubCo may render Elegance Ltd subject to VAT, but this is outside the scope of this report.

(b) Query 2: Factory acquisition

(1) Indirect acquisition of shares in Xytec Ltd
There are non-tax risks involved in acquiring Xytec Ltd rather than the factory itself in relation to the potential for contingent liabilities being realised post-sale. Should there be any regulatory requirements which have not been met, these would become the burden of SubCo. Further, a tax is levied on the transfer of the shares.

(2) Direct acquisition
It would be better to acquire the factory directly from Xytec Ltd. As this is the company's only asset (as a rental property), it may be sold to SubCo (assuming both parties are registered VAT vendors) at the zero rate under the conditions applicable to the sale of a going concern. As the building will be used in the making of taxable supplies (i.e. the manufacture of chocolate on the premises), no change of use adjustment will be required. Alternatively, should the zero rating not be possible, then the VAT paid (at the standard rate of 15%) may be claimed as an input against the outputs. Transfer duty will not be applied on this acquisition as VAT has been levied (noting that it does not matter whether the VAT was levied at 0% or 15%).

(c) Query 3: Machinery and electrical generation equipment
You have indicated that all of the machinery will be imported from Chocoland. You have further provided a breakdown of values which you have obtained. We provide calculations to support our discussions utilising those figures as the base.

(i) VAT implications for SubCo of importation of machinery from Chocoland
On importation of the machinery, a VAT charge is triggered (payable by SubCo assumed to be registered for VAT in South Africa) and is collected by the Department of Customs and Excise. The same charge may be claimed as a VAT input against the VAT output amounts collected. The amount of such charge will be: R12,626,087 [{R84,000,000 (customs value) + R4,000,000 (customs duty)} x 110% x 15/115].

(ii) Income tax deductions in respect of machinery and electrical generation equipment
For income tax purposes, the cost will be:

Cost at acquisition: CCL 5,000,000 x 16·0 = R80,000,000
Add customs duty: R4,000,000

On the total cost of R84,000,000, a capital allowance will be permitted. 40% of this value (i.e. R33,600,000) may be claimed in the first year and 20% (i.e. R16,800,000) in each of the three successive years of use.

Furthermore, there will be a foreign exchange difference to be recognised as a result of the acquisition cost remaining unpaid. This exchange gain or loss will be recognised only at the end of the year of assessment or on realisation of the debt. Using the year-end exchange rate of CCL 1 = ZAR 16·6, then a loss of R3,000,000 ((16·60 – 16·0) x CCL 5,000,000) would be recognised. Should you anticipate a weakening Rand, it may be worthwhile obtaining a forward exchange contract.

Apart from any regulatory approval you may need to seek, capital allowances are granted on the acquisition and installation of electrical generation equipment. These allowances are aimed specifically at use of the generated power in the trade. You are considering wind and photovoltaic power generation. While the Act distinguishes between photovoltaic power of greater than 1 MegaWatt or equal to or less than 1 MegaWatt, nothing turns on this stratification for your purposes. It facilitates allowances on wind power generation equipment. As you have not provided illustrative figures, we supply the allowance percentages, being 50% of the acquisition cost in the first year in which it is brought into use and 30% and 20% in the successive two years. Note that the acquisition cost will include the costs of any permanent structures to which the equipment is secured. It is submitted that the battery costs for storage of the power for later use also fall within this allowance.

(d) Query 4: Intellectual property and tax minimisation

(i) Treatment of royalties and management fee

The South African tax consequences of the royalty payments in respect of the use of intellectual property and training of staff and the management fee to be made to Elegance Ltd are as follows, before taking into account any tax treaties:

Use of intellectual property (the secret blend formula):

This is a royalty payment and a deduction for SubCo. Furthermore, the South African legislation classifies this payment for the use of intellectual property as from a South African source. This means that Elegance Ltd is taxable on this amount in South Africa. The South African tax legislation facilitates a final withholding tax of 15% of the royalty payment. In your case, you are proposing a royalty charge of R12,500,000 (being 25% of R50,000,000). This in turn means a final withholding tax of R1,875,000 (15% x R12,500,000). The amount of R12,500,000 would qualify as a deduction for SubCo (being a recurrent payment for the use of intellectual property). These values are, however, subject to the transfer pricing discussion in (ii) below.

Training of staff:

Whether any royalty withholding tax must be withheld depends on whether the training represents either the transfer of knowledge ('know-how'), demonstration to and upskilling of the staff to apply the secret blend formula ('show-how') or simply general staff training. For the former two categories, the royalty withholding tax would be applied, as for the secret blend formula intellectual property above.

For all categories, the amount paid to Elegance Ltd would be a deduction for SubCo. For Elegance Ltd, this income in respect of training would be from a South African source and therefore taxable in South Africa. The 15% royalty withholding tax is applicable on the fees paid by SubCo for such training.

Management fee charged:

The management fee is for services rendered to SubCo from Elegance Ltd in Chocoland. In this instance, it is doubtful that the service is from a South African source and therefore is not taxable for Elegance Ltd in South Africa. Of course, the fee charged is deductible for SubCo. The management fee is R5,000,000 (10% of R50,000,000).

(ii) Anti-avoidance provisions

For all of the fees above, an issue may arise as regards the quantum of the amounts charged. You have indicated that the charges to SubCo are higher than those charged to others globally and have been levied on a different basis. Such a deviation will need to be justified from a transfer pricing perspective. While you have indicated that the higher fees have been charged due to risks associated with the set-up of new operations, you have provided no evidence that such a policy is followed by the company globally. The transfer pricing methodology adopted and the transfer pricing policy document would have to provide evidence that these prices are at arm's length.

You have indicated that, at least to some extent, the prices are motivated by the higher corporate tax rate in South Africa. This may be interpreted as an attempt to shift profits from a higher tax jurisdiction to a lower tax jurisdiction, in which case a transfer pricing adjustment may be required. To illustrate the potential impact of the transfer pricing provisions in South Africa, the illustrative figures you have supplied will be used.

Royalty charged to local entity: R50,000,000 x 25% = R12,500,000
Arm's length royalty: R50,000,000 x 20% (to get to EBITDA) x 50% (royalty charge) = R5,000,000

The primary adjustment would be the disallowance of R7,500,000 (R12,500,000 – R5,000,000) as a deduction for SubCo (being the difference between the amount charged and the arm's length price). The secondary adjustment would deem the R7,500,000 to be a dividend *in specie*. Such a classification renders SubCo liable for dividends tax at 20% of that amount, i.e. R1,500,000 (20% x R7,500,000).

Similarly, the management fee also seems to be higher than your global standard. While this may be justified as well, the supplied reason in your email concerns the South African tax rate and therefore appears to be a form of profit shifting behaviour. The impact would be:

Management fee charged to local entity: R50,000,000 x 10% = R5,000,000
Arm's length management fee: R50,000,000 x 20% (to get to EBITDA) x 10% (global management fee) = R1,000,000

The primary adjustment would be the disallowance of R4,000,000 (R5,000,000 – R1,000,000) as a deduction for SubCo (being the difference between the amount charged and the arm's length price). The secondary adjustment would deem the R4,000,000 to be a dividend *in specie*. Such a classification again renders SubCo liable for dividends tax at 20% of that amount, i.e. R800,000 (20% x R4,000,000).

(e) Query 5: Tax treaty issues

The most critical impact on the information as supplied in this report is the amendment to the rate of withholding tax applicable to the royalty payment. While the standard withholding tax is 15% in terms of South African law, the South Africa–Havia treaty reduces the rate effectively to nil as no taxing right remains with South Africa after the application of the treaty. It would seem further that, following the transfer by Elegance Ltd of the intellectual property to the intermediary company in Havia, the Havian company would, in fact, be the beneficial owner of the royalty payment. However, the transfer pricing adjustment as applied to SubCo is unlikely to change. Further, the secondary adjustment is a dividend *in specie* rendering SubCo liable for that payment and not the shareholder.

Dividends have not yet been discussed in this report. In the absence of the treaty (i.e. should SubCo pay a dividend directly to Elegance Ltd with no intermediary company in existence), the withholding tax applicable would be levied at 20%. By structuring through Havia, the dividend withholding tax is reduced to 1%. The on payment of dividends from the Havian company to Elegance Ltd are not subject to tax. Here, however, it may be argued by SARS that the Havian company is not the beneficial owner of the dividend. If the beneficial ownership of the dividend received by the Havian company cannot be defended, then the rate of withholding tax would revert to the 20% ordinarily levied in terms of the South African legislation.

2 Mr Freiheit

(a) Residence in South Africa

There are two tests for residence for income tax purposes in South Africa. The first test is the legal subjective test, namely where the person is 'ordinarily resident'. The second test for residence is the physical presence test.

In previous years, Mr Freiheit is unlikely to have been considered 'ordinarily resident'. He left South Africa at the age of 22. Even if he remained a citizen, that is insufficient to consider him ordinarily resident. Case law reveals that the test is essentially one of the place to which the person would return to from their wanderings. Such a place would remain the place of ordinary residence despite absences of long or short duration. However, it is submitted that an absence of 18 years should be sufficient to have ceased being ordinarily resident. He would not have been resident in terms of the physical presence test either as his presence in South Africa was approximately 28 days per year, far below the first requirement of 91 days in the current year of assessment.

It is submitted that Mr Freiheit is not currently resident in South Africa for tax purposes. However, his intention now is to settle in South Africa and run his operations from South Africa. This intention indicates that Mr Freiheit wishes to make South Africa his true home. It is therefore submitted that irrespective of the physical presence in South Africa, Mr Freiheit would become resident in South Africa in terms of the ordinarily resident test from 1 December 2020. Should any circumstance arise which indicates that Mr Freiheit will not consider South Africa his true home, then he will only become resident on meeting the conditions of the physical presence test.

(b) Timing of disposal of shares

Sale on 30 December 2020

Mr Freiheit will reset the base cost of the shares at the market value on the date he becomes resident in South Africa (i.e. on 1 December 2020). From the supplied information, the value of the shares is estimated to be FRZ 5,000,000 on change to a South African resident. The value on 30 December 2020 (the date of sale) is expected to rise to FRZ 5,300,000. This would be the sale of a foreign asset acquired and sold in the same currency. The capital gain would be determined by calculating the gain in the foreign currency before converting to Rands at the average exchange rate for the year of assessment. The means that the gain would be determined as follows:

	FRZ	Rate of exchange	ZAR
Proceeds	5,300,000		
Less base cost	(5,000,000)		
Capital gain	300,000	11·7	3,510,000
Less annual exclusion			(40,000)
Net capital gain			3,470,000

R3,470,000 (assuming no other capital gains) would be included in Mr Freiheit's taxable income and subjected to the marginal rate of tax applicable (in this case, likely the maximum of 45%).

Sale on 30 November 2020
If, instead, Mr Freiheit sells the shares before becoming a resident, no South African capital gains tax will be levied as he will not be resident. As no capital gains tax is levied in Freezania, the capital would not be eroded by the South African tax which would otherwise have been levied and he would have more funds available to spend on his house and furnishings. Converting the foreign currency to Rands on entry into South Africa would not attract capital gains tax consequences since currency is not chargeable to capital gains tax.

(c) (i) Presence in South Africa and impact on residence of MobiFree Ltd
Should Mr Freiheit become resident on 1 December 2020 before a managing director is put in place, the consequences may be significant. The definition of resident for non-natural persons provides that a company may be resident if it is incorporated in South Africa OR has its place of effective management in South Africa. Mr Freiheit, by becoming a resident and continuing to manage MobiFree Ltd in Freezania from South Africa, may inadvertently cause the company to become resident in South Africa. Of course, this submission does hinge on MobiFree Ltd being considered to have its place of effective management in South Africa. Mr Freiheit (if resident from 1 December 2020) is not only the majority shareholder, but also runs the operation remotely (i.e. wherever he is). Further, as the managing director, he directs the day-to-day operations and, it would appear, the strategy the company will follow. This would seem to be sufficient for the place of effective management of MobiFree Ltd to be South Africa.

(ii) Controlled foreign company (CFC) status and exemptions
If Mr Freiheit's presence and conduct of the operations is insufficient to render MobiFree Ltd resident in South Africa by virtue of its place of effective management, then his ownership of the company (as a resident of South Africa) would render MobiFree Ltd a CFC. Mr Freiheit holds more than 50% of the participation rights in the company and is resident in South Africa.

The main implication of CFC status is that the profits of the company will be attributed to, and taxed on, the South African shareholders. However, this income attribution will not be made if certain conditions regarding the rate of tax paid overseas or the extent to which there is a physical establishment overseas are met.

Foreign tax rate threshold exemption
First, regarding the rate of tax paid overseas, the income attribution is not prevented with reference to the 10% corporate tax rate in Freezania, being below 75% of the South African tax (i.e. below 21% (28% x 75%)) which would have been charged on determined 'net income'.

Assuming the net profit of MobiFree Ltd to be the same as net income for CFC purposes, the South African corporate tax would be: FRZ 20,000,000 x 11·7 x 28% = R65,520,000 whereas the Freezania corporate tax equivalent in Rands is FRZ 20,000,000 x 11·7 x 10% = R23,400,000 (only 36% of the South African tax). Accordingly, the foreign tax rate exemption will not apply.

Foreign business establishment exemption
Second, regarding the extent to which there is an overseas physical establishment, the net income may be excluded should the business qualify as a foreign business establishment. Currently, MobiFree Ltd would not qualify as a foreign business establishment unless it meets the following conditions:

- The company would have to operate from an office in Freezania – this condition may be met, but it is currently unclear as to whether it is a 'letterbox' company operated virtually by Mr Freiheit or has actual presence. It may have presence in the future as it is indicated that Mr Freiheit will be appointing a local managing director.
- Such an office or place must be staffed by on-site managerial and operational staff conducting the primary operations. An on-site managing director is planned to be appointed on 1 January 2021. This implies that there will be a formal space and managerial structure in Freezania. However, there should also be operational staff. A single employee (whatever the title) cannot manage themselves. It further seems that most of the work is co-ordinated by Mr Freiheit and is conducted by freelance contractors who are based in various countries rather than in Freezania.
- The place of business must be suitably equipped for the operations. Here, presumably, the company has servers in place to manage the apps and the sales.
- The company (linked to the previous criteria) has suitable facilities to conduct its operations.
- Its place of business is not solely or mainly for the reduction or postponement of any South African tax. This is clearly met as the company was created in Freezania while Mr Freiheit was non-resident.

(iii) Implications of CFC status for Mr Freiheit
If none of the CFC exemptions apply, there will be an attribution of MobiFree Ltd's profit to Mr Freiheit in relation to his holding. This attribution looks further to be in excess of the regular dividend payout (which would be free of tax in South Africa under the participation exemption) and will therefore lead to an increased tax liability. This is despite the credit of the Freezanian tax which would be granted to Mr Freiheit in respect of the attributed income.

Illustrative effects:

	R
Attribution of Freezanian company profit: 51% x R20,000,000 x 11·7	119,340,000
South African tax on attributed profit: (R119,340,000 – R1,500,000) x 45% + R532,041	53,560,041
Less rebate	(14,220)
Less attributed corporate tax: R23,400,000 x 51%	(11,934,000)
Net South African tax liability	41,611,821

This calculation ignores the South African tax on the amount received as directors fees/salary. Further, the dividend received from the company would be exempt from tax due to the participation exemption.

(iv) Deferring the date Mr Freiheit becomes South African resident

Should Mr Freiheit defer his residence until he can ensure that the foreign business establishment conditions (as discussed in (ii) above) are met, then the adverse attribution consequences under the CFC rules will be mitigated. The net income attributable to Mr Freiheit would be reduced to nil. The foreign dividend would remain exempt (due to his equity share participation exceeding 10% under the participation exemption). The only amount which will be taxable will be the directors fees received. The tax levied in Freezania on the directors fees would be creditable against his South African tax liability.

(v) Value added tax (VAT) implications of directors fees

Mr Freiheit (as a non-executive director once chairman of the board) for MobiFree Ltd is rendering his services from South Africa. His earnings are approximately FRZ 700,000 x 11·7 = R8,190,000. This exceeds the taxable supplies threshold of R1 million for VAT purposes. In terms of the Binding General Rulings issued by the South African Revenue Service (SARS), such non-executive director services are that of an independent contractor and not an employee.

While Mr Freiheit will be required to register for VAT, he may be supplying a zero-rated supply (meaning the VAT is charged on the taxable supply at 0%). The conditions which must be met are that the services are rendered to a non-resident who uses those services outside South Africa and that person (MobiFree Ltd) is not resident of South Africa at the time the services are rendered). While Mr Freiheit will need to render VAT returns, the outputs will be nil, but he will be able to claim inputs on costs incurred in relation to his supply of those services.

3 Dr Jalka

(a) Loss of income

Loss of income insurance policy and collective investment scheme (CIS)

The premiums paid for a loss of income insurance policy are specifically denied as deductions and so there is no tax relief for this business expense despite the fact that the income being replaced is trade income. However, should the event occur for which the policy must pay out, then the proceeds are also exempt from taxation. The tax implications are therefore balanced.

Should Dr Jalka self-insure his risk using a CIS, again there is no deduction available for the contributions he makes into the scheme. Depending on the investment, he will be subject to tax on the return on the investment (which erodes the value) and further to capital gains tax on the capital should the event occur which requires him to draw from this 'self-insurance'.

Tutorial note: *There are non-tax advantages and disadvantages to loss of income insurance policies and collective investment schemes, but identification of these matters was not required.*

(b) Retirement and emigration

(i) Advantages of retirement annuity funds

There are a number of tax benefits related to contributions to retirement annuity funds. First, there is the income tax relief in respect of contributions to the retirement annuity fund which may be set off against the private practice earnings. The contributions being made are the maximum that may be made in each year of assessment under the current legislation. The contribution of R350,000 to a retirement annuity fund currently provides a tax saving of R157,500 (45% highest marginal rate x R350,000 maximum contribution).

Second, the income which accrues on the underlying investments in the retirement annuity fund are not subject to tax in the hands of the retirement annuity fund holder. This prevents erosion of the capital, facilitating (potentially) greater growth in the retirement savings.

Third, on retirement, up to one-third 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%. At least two-thirds (or any greater balance if less is taken as a lump sum) will 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 last tax benefit is the exclusion of retirement annuity fund balances from property for the purpose of estate duty.

(ii) Using tax-free investment and share portfolio to increase foreign exposure

Increasing Dr Jalka's offshore investment may be achieved to some extent in the choice of underlying portfolios in the tax-free investment. This is limited to an overall cap of R500,000 which will be insufficient for retirement. The investment returns and realisation of the tax-free investment are free of normal income tax (including capital gains tax).

Investing in other asset types offshore will yield different income tax consequences depending on the nature of the investments. However, as Dr Jalka indicates an intention to utilise his share portfolio, investment in foreign shares is indicated. It is doubtful that the shareholdings will be of the amount to be subject to special foreign dividend exemptions, but more information would be needed to discuss such aspects further.

This means that the foreign dividends would likely be subject to the general foreign dividend partial exemption (which is 25/45 of the foreign dividend inclusion). The foreign dividend income will be included in Dr Jalka's taxable income at the spot rate on the date the dividend is paid, but the foreign tax credited is translated at the average exchange rate for the year of assessment. Any changes in Dr Jalka's underlying investments (e.g. selling one share to buy another share) will result in capital gains tax while he is resident in South Africa. These are foreign disposals and so the proceeds and base cost will have to be translated to Rands in accordance with the rules for foreign assets (i.e. at the average rate of exchange for that year of assessment).

For estate duty purposes, the investments held at death (if Dr Jalka is still resident at the time), would fall into his estate. This will apply to the tax-free investment and the investments other than the retirement annuity fund balances.

(iii) Impact on retirement annuity fund and investments if emigration before retirement

Withdrawal

Should Dr Jalka emigrate before retirement, two options exist with respect to his retirement annuity fund. First, he could withdraw the full amount. This will have a significant punitive tax effect, but will free this money for future investment either within or outside South Africa. Further, as the amount received will be cash, there would be no capital gains tax on exit. Using the current amounts accumulated to illustrate the impact, the capital of R5,000,000 if withdrawn would generate a tax liability of R1,647,000 (being (R5,000,000 – R990,000) x 36% + R203,400).

Wait for maturity after emigration

If left in South Africa, the funds may be preserved in the fund until retirement age. At this point, the lump sum would accrue and the amount would become taxable when withdrawn. One-third could be withdrawn as a lump sum and the remaining amount extracted as an annuity. As there is no tax treaty, the amounts would remain taxable in South Africa. As illustrative of the impact, taking a full third as a lump sum (noting this is the maximum and not prescriptive) would result in tax of R352,500 (being (R5,000,000/3 – R1,050,000) x 36% + R130,500). The balance drawn as an annuity would yield low tax as, assuming emigration has taken place, the progressive tables and rebates would limit the effect of normal tax. However, no protection against the volatility in the Rand is provided for.

Investment holdings

The emigration would also trigger an exit tax on all shareholdings. This would effectively realise the unrealised share gain. Liquidity is an issue with the exit tax and unless sufficient cash resources exist to fund the exit tax, assets would have to be sold to cover the cost. This would result in an actual realisation of an asset. Thereafter, any future gains after residence has ceased will no longer be subject to normal tax in South Africa. This would apply to both South African and foreign shareholdings.

From an estate duty perspective, any shares held in South Africa where the transfer of the shares must be recorded in South Africa would form part of a South African estate for estate duty purposes for a non-resident.

(iv) Sale of private practice

The sale of the private practice as a sole trader would, in fact, be a sale of all the underlying assets (including goodwill – determined as the difference between the values achieved for the sale of the underlying assets and the total consideration). The sale of these assets will trigger a host of income tax effects, including recoupments of allowances claimed on depreciable assets in use and capital gains tax (potentially) on the disposal of assets (including goodwill). Furthermore, unless sold as a going concern to another value added tax (VAT) vendor and the election is made in writing to zero rate the sale, VAT would be levied on the disposal of all the assets at the standard rate of 15%. Although technically this VAT would simply be added to the agreed sales price, the purchaser would be disadvantaged, either just in cash flow terms or in actual terms if he is unable to recover all the VAT. Either way, the fact of VAT being charged could result in Dr Jalka having to accept a lower ex-VAT price.

Selling the business before emigration would allow for the realisation of the assets and cash would be available for any other exit taxes on the investment portfolio. Retaining the business after emigration would probably result in a devaluation of the business because Dr Jalka would not be personally conducting the services). However, as a tax consideration, the retention of the business will represent a permanent establishment operating in South Africa. This will have the effect of retaining the capital gains tax consequences on actual disposal (while eliminating the exit tax on emigration on the business and the assets attaching to that permanent establishment). A disposal subsequent to emigration (if in a new tax year) may also facilitate use of the progressive tables to reduce the tax burden, if early in a new fiscal year.

4 (a) Space4U Ltd

Sale of property assets – Space4U Ltd

The proposed sale of Space4U Ltd's property assets to Equitas Commercial Property Fund would trigger the corporate rule for amalgamation transactions. This transaction would qualify under this rule as Space4U Ltd, a South African resident, would be disposing of all of its assets to Equitas Commercial Property Fund (which is a company as defined and resident in South Africa) by means of an amalgamation and as a result of the transaction, the existence of Space4U Ltd will be terminated.

All of the assets being disposed of by Space4U Ltd are held as capital assets. The disposal to Equitas Commercial Property Fund would be deemed to be disposed of at the base cost of these assets. This implies that the transaction would be tax neutral for Space4U 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 Space4U Ltd and the capital gains tax implications would remain the same (i.e. a disposal to Equitas Commercial Property Fund at base cost).

The three properties which will be disposed of are located in South Africa. Since Space4U Ltd and Equitas Commercial Property Fund are both registered value added tax (VAT) vendors, it would be beneficial for them to agree in writing to dispose of these assets as a going concern so as to facilitate a transfer of the properties at the zero rate for VAT purposes. To qualify for the zero rate:

(i) The seller and purchaser must be registered vendors.

(ii) The supply must consist of an enterprise or part of an enterprise which is capable of separate operation.

(iii) The parties must agree in writing that the supply is a going concern.

(iv) The seller and purchaser must, at the conclusion of the agreement, agree in writing that the enterprise will be an income-earning activity on the date of transfer thereof.

(v) The assets necessary for carrying on the enterprise must be disposed of to the purchaser.

(vi) The parties must agree in writing that the consideration for the supply includes VAT at the zero rate.

Further, as VAT would have been levied (albeit at the zero rate), transfer duty would not be applicable.

Finally, the liquidation dividend declared by Space4U Ltd would be subject to the provisions of dividends tax. To the extent the dividend is not subject to any dividends tax exemption, dividends tax would be withheld at 20% of the final dividend and payable to the South African Revenue Service (SARS) on behalf of the shareholders.

(b) Global Manufacturing Ltd

Before any roll over may be contemplated, the effects of the disposal of the machine by the Shemland branch must be considered. Despite no allowances being applied in Shemland, the machine is used in a process of manufacture and the Shemland operations are merely branch operations, so allowances are claimable for South Africa.

For capital allowance purposes, the machine would be translated to Rands at the spot rate on acquisition, being: USD 100,000 x 15 = R1,500,000. Capital allowances claimed up to and including the 2020 year of assessment would be:

2018 – 40% x R1,500,000 =	R600,000
2019 – 20% x R1,500,000 =	R300,000
2020 – 20% x R1,500,000 =	R300,000
	R1,200,000

This means the tax value at date of sale was R300,000 (R1,500,000 – R1,200,000). Similarly, for recoupment of these allowances, the sale value would be translated at the spot rate: SHM 75,000 x 20·2 = R1,515,000. The recoupments would be limited to the amounts previously claimed, i.e. R1,200,000.

For capital gains tax purposes, this sale is the sale of an asset acquired in foreign currency and sold in a foreign currency. The legislation provides for the choice of translation of the values at the relevant average exchange rates or the spot rates and therefore the most advantageous rates may be chosen. For capital gains tax it is generally best to elect the lower rate for proceeds and the higher rate for base cost, i.e.:

Proceeds: SHM 75,000 x lower of 20·2 or 21·0 (use 20·2) = R1,515,000
Base cost: USD 100,000 x higher of 15·0 or 15·5 (use 15·5) = R1,550,000

However, in this instance and using these values, the result is a capital loss:

	Using 'best' rate		Achieving roll over	
	R	R	R	R
Proceeds				
Sales price at lower elected rate (20·2)	1,515,000			
Sales price at higher elected rate (21·0)			1,575,000	
Less recoupment	(1,200,000)	315,000	(1,200,000)	375,000
Base cost:				
Acquisition cost	1,550,000		1,550,000	
Less allowances: (80% x R1,500,000)	(1,200,000)	(350,000)	(1,200,000)	(350,000)
(Capital loss)/capital gain		(35,000)		25,000

This would prevent the election of the roll over provisions and the full recoupment would have to be recognised for normal tax and, in the absence of any other capital gains, the loss would be carried forward. If the company elects the average exchange rate for the year of disposal, roll over may be elected as a capital gain is then realised.

This means that the recoupment of R1,200,000 may be spread over the tax-useful life of the new machine, i.e. only 40% recognised in the first year. This may assist in managing cash flow. That the full payment is only received later does not remove from the fact that the full proceeds are used against the acquisition of the new machine.

The receipts in instalments from the buyer of the machine in Shemland creates an exchange item for which any unrealised and (ultimately) realised foreign exchange gains or losses must be calculated. At the year end, the buyer owes SHM 37,500 (SMH 75,000 x 50%). The Rand has weakened against the SHM creating an unrealised exchange gain, being: SHM 37,500 x (20·8 – 20·2) = R22,500. In the year ended 31 December 2021, the amount is paid, at which point the Rand has strengthened relative to the year-end rate, creating an exchange loss, being: SHM 37,500 x (20·5 – 20·8) = R11,250.

	Available	Maximum
1 Elegance Ltd		
(a) General tax overview		
Identify corporate income tax levied and rate of tax	1	
Identify possible initial assessed loss position	1	
Identify need to register for value added tax (VAT)	1	
Identify need to register for VAT prior to import of machinery	½	
Identify need to withhold employees tax	1	
Explain need for representative for Elegance Ltd as regards seconded employees	1	
	5½	4
(b) Factory acquisition		
Identify no advantage to indirect acquisition of factory	½	
Identify risk of indirect acquisition	1	
Explain potential for zero rating acquisition and identify no change in use adjustment	1½	
If zero rating not possible, input VAT can be reclaimed	1	
Identify no transfer duty applicable due to VAT either way	½	
	4½	4
(c) Machinery and electricity generation equipment		
(i) Identify and calculate VAT on importation of machinery	2½	2
(ii) Calculate cost for capital allowance purposes	1	
Identify capital allowances to be claimed	1	
Demonstrate and calculate foreign exchange difference	1½	
Identify capital allowance rates for electrical generation equipment	1	
Identify equipment inclusions	1	
	5½	5
(d) Intellectual property and tax minimisation		
(i) Identify intellectual property royalty as South African source income for Elegance Ltd	½	
Calculate withholding tax and deduction for Elegance Ltd and SubCo respectively	2	
Identify deduction for SubCo	½	
Identify and explain two possible treatments for training fees and withholding tax rate	2½	
Identify deduction for management fee charged to SubCo and calculate amount	1	
Identify exclusion from source for income for Elegance Ltd	½	
	7	6
(ii) Identify risk of transfer pricing and why risk may arise	2	
Explain what may be required to justify prices set	1	
Calculate illustrative transfer pricing on royalty charge	2	
Calculate illustrative transfer pricing on management fee	2	
	7	6

		Available	*Maximum*
(e)	**Tax treaty issues**		
	Identify reduction in royalty withholding tax rate	1	
	Explain beneficial owner likely to be Havian company	1	
	Identify transfer pricing adjustments unaffected	1	
	Identify reduction in dividends withholding tax rate	1	
	Identify beneficial ownership argument may impact treaty relief	1	
		5	4
Professional marks			
Format and presentation of the letter		1	
Effectiveness of communication:			
	Extent to which communication directed to the audience	1	
	Discussion focused on the scope of work (i.e. the queries and no irrelevant information included)	2	
		4	4
			35

		Available	Maximum
2	Mr Freiheit		
(a)	**Residence in South Africa**		
	Identify two tests of residence	1	
	Explain test of 'ordinarily resident' and apply to facts	2	
	Explain why he is not resident under physical presence test	1	
	Explain how change of intention triggers ordinarily resident	1	
		5	5
(b)	**Timing of disposal of shares**		
	Explain and calculate South African capital gains tax implications of disposal on 30 December 2020	3	
	Explain implications of disposal on 30 November 2020	2	
		5	4
(c) (i)	**Presence in South Africa and impact on residence of MobiFree Ltd**		
	Identify risk based on definition of residence for non-natural persons	1	
	Explain why place of effective management may change with Mr Freiheit's change of residence	2	
		3	3
(ii)	**Controlled foreign company (CFC) status and exemptions**		
	Identify why the company would be a CFC	1	
	Explanation of and supporting calculation for the exemption from CFC attribution with reference to the foreign tax rate being inapplicable	3	
	Explanation of and application to the facts of the exemption requirements applicable to a foreign business establishment	3	
		7	5
(iii)	**Implications of CFC status for Mr Freiheit**		
	Explain implications of CFC status for Mr Freiheit	1	
	Provision of illustrative calculations	2	
		3	3
(iv)	**Deferring the date Mr Freiheit becomes South African resident**		
	Identify actions to be taken and completed before Mr Freiheit becomes resident	1	
	Explain implications on South African tax liability	2	
		3	2
(v)	**Value added tax (VAT) implications of directors fees**		
	Identify VAT registration for non-executive directors	1	
	Calculate amount earned and identify above VAT threshold	1	
	Explain why service is zero rated and implication	2	
		4	3
			25

	Available	Maximum
3 Dr Jalka		
(a) Loss of income insurance policy and collective investment scheme (CIS)		
Identify tax implications for loss of income policy premiums and payout	1½	
Identify tax implications for 'self-insurance' CIS savings and realisation	1½	
	3	2
(b) Retirement and emigration		
(i) Advantages of retirement annuity funds		
Explain the four advantages for retirement annuity funds in South Africa across income tax and estate duty	4	4
(ii) Using tax-free investment and share portfolio to increase foreign exposure		
Identify the lack of restriction on underlying investment type for tax-free investment	½	
Identify that the tax-free investment amount is capped	1	
Explain the normal tax consequences for income arising from foreign share investments	2	
Identify the capital gains tax consequences (while a resident)	2	
Identify the estate duty consequences	1	
	6½	5
(iii) Impact on retirement annuity fund and investments of emigration before retirement		
Explain and illustrate tax effects of withdrawal of retirement annuity funds before emigration	2	
Identify effects on exit of leaving money in the fund	1	
Identify effects after emigration on retiring from the fund and illustrate with calculations	2	
Identify exit tax on shareholdings on ceasing to be resident and lack of capital gains going forward	1	
Identify potential risk for South African shareholdings for estate duty purposes	1	
	7	6
(iv) Sale of private practice		
Identify the normal tax effects of disposal	1	
Identify the consequences of a going concern sale or standard rate sale for value added tax (VAT) purposes	1	
Identify the normal tax implications of selling before emigration	1	
Identify the consequences of a permanent establishment arising from the business if continued after emigration	1	
	4	3
		20

			Available	Maximum
4	**(a)**	**Space4U Ltd**		
		Identify amalgamation transaction applies	1	
		Explain qualification under the rule	2	
		Explain capital gains tax and allowance implications for Space4U Ltd	2	
		Identify possibility of going concern disposal	1	
		Identify conditions for going concern disposal	2	
		Identify no transfer duty applicable	1	
		Identify application of dividends tax	1	
			10	10
	(b)	**Global Manufacturing Ltd**		
		Explain why capital allowances remain applicable (with calculations)	2	
		Calculate application recoupment	1	
		Explain currency conversion choice for capital gains tax	1	
		Provide calculations to demonstrate options	2	
		Identify that roll over only applies where a capital gain is realised	1	
		Explain value of roll over and how it can be achieved, referring to cash flow advantage of spreading recoupment over several years	2	
		Effect of instalment sale and calculation of exchange gains and losses on instalment sale of machine	2	
			11	10
				20