

Tax Professional

Final Integrated Summative Assessment

2014 Sample Paper

Paper 2: Question

Instructions to Candidates

1. This final integrated summative assessment paper consists of one question.
Time: 4½ hours plus ½ hour reading time
2. Enter your examination number on the cover of each answer book as well as on all answer sheets.
3. Your name must not appear anywhere in the answer books.
4. Answers may not be written in pencil and correction pens (tipex) may not be used.
5. Answer the questions using effective presentation and pay particular attention to the use of concise language, clarity of explanation and logical argument. Marks will be awarded for these aspects of your response.
6. It is your responsibility to ensure that all answer books are handed in to the invigilator before leaving the examination room, as answer books handed in thereafter will not be marked.

Green Garden Limited (Green Garden) is a public company with a 28 February year-end. The company is a resident of South Africa for tax purposes. The company's primary business is to sell gardening products (fertilizers and other similar products) on a wholesale and retail basis.

The activities of the company have attracted the attention of the SARS (South African Revenue Service) in recent times. These events have caused Green Garden to dismiss its current auditors, a small auditing firm that has been assisting the company with preparing its financial statements, who performed all tax related work as well as the audit. This has prompted the financial director, Mr White, to engage your services to assist that damage control, as he puts it, is done where necessary in respect of the company's tax affairs.

Following an initial meeting with you earlier today, the following email message (with the attachments) was sent to you by Mr White:

1. Email following the meeting

Tuesday, 16 September 2014

From: mrwhite@greengarden.co.za

To: taxexpert@taxspecialists.co.za

Subject: Matters discussed today

Dear Mr Expert

It was a pleasure meeting you today and we look forward to making use of your services on a regular basis.

At your request, I would like to summarise the facts discussed:

- (1) Based on an audit conducted by the SARS into our 2012 tax assessment an additional assessment was issued. I have attached this additional assessment for your reference [*refer attachment 1*].

In brief, the background to the findings and our initial assessment of these findings are as follows:

BEE transaction

The first finding relates to compost manufacturing plant and building (acquired in 1988) that were transferred into a subsidiary established to empower these assets. These assets were transferred into the subsidiary, NewGard (Pty) Ltd, which at the time was a wholly owned subsidiary of Green Garden. NewGard paid for the business by issuing its own shares to Green Garden. Following this transaction, 30% of the shares of NewGard were issued to a BEE trust of which some qualifying employees of Green Garden are the beneficiaries.

An additional assessment of R3 million was raised as a recoupment of section 12C and section 13 allowances previously claimed in respect of the manufacturing plant. In addition, a capital gain of R10 million was included for the sale of the building, which has appreciated in value since acquisition. This recoupment and capital gain appear to be based on the estimated market values of the items that were stipulated in a valuation report obtained for purposes of determining the value at which the BEE trust acquired the shares of NewGard.

Dust Garden shares

The second matter deals with a 51% shareholding that we acquired in a struggling fertiliser business, Dust Garden Ltd (Dust Garden), on 1 July 2011. Our CEO, Mr Optimul, has been negotiating the deal since early 2010 but the previous owners only agreed to it mid-2011. Green Garden borrowed the purchase price of R10 million from a local bank for a period of four years, which at the time seemed a realistic turnaround time. Mr Optimul and the seller agreed to a transaction in terms of which we (Green Garden) would assist Dust Garden in reviving its business provided that we acquire a controlling interest in the company.

The turnaround was amazing and within seven months we received an offer for the shares that we could not turn down. The shares were therefore sold during February 2012 for R17 million.

We were of the view that the shares were always held on capital account and therefore declared a capital gain in our return, but the SARS raised the additional assessment indicating the proceeds of R17 million as gross income. It is however not clear whether or not this is correct.

Fertiliser sales

As we see it, the last one is unfortunately a sitter that they found and that we would have to live with.

We sell certain popular fertilisers to avid gardeners. The supplier allows us to send any product back to them if it stays on the shelves for longer than six months. The flip side of the transaction is however that 10% of the proceeds (commission for the effective branding) from any product sold within three months must be paid to the suppliers. For these purposes, it was agreed with the supplier that all monies flowing between Green Garden and the supplier as well as sales of the product would be kept in a separate bank account of which Green Garden could give the supplier copies of the statements without divulging information about the rest of its business. The auditors made the mistake of missing this bank account when preparing the financial statements. Due to the fact that this account was not included in the financial statements, the transactions were not taken into account for normal income tax purposes at all. The SARS discovered the account during the audit and included the transactions in 2012 (both sales to customers and payments made for the purchase and commission to the supplier) in the additional assessment.

- (2) The findings of the SARS in respect of the fertiliser sales (last point in (1)) raised a further concern. Green Garden is a VAT vendor. Our staff members who administered these sales through the bank account referred to above, were initially so baffled by the new administration process that they never considered charging VAT on the sales. This

practice has remained unchanged and was never questioned as the auditors were not aware of the account.

As the supplier is not a VAT vendor, no VAT was charged on the invoices for fertiliser supplied to us. We are concerned that it is only a matter of time before the SARS also identifies the VAT non-compliance. These transactions have been taking place for the past 11 years and we estimate the annual sales to be in the region of R1,2 million, while the purchases and commission should be approximately R800 000 per annum.

We have highlighted our concern to the previous auditors prior to dismissing them. They have however indicated that we do not need to worry as we have not claimed input tax, which according to them is the biggest risk. In addition, they indicated that the sale of fertiliser is a zero-rated supply for VAT purposes. They have also suggested that should any further risk become apparent, the best way to solve this would be to draw up a document stating we were acting as agents on behalf of the supplier and back-dating it to 2004 when the transactions started.

- (3) Find attached the financial statements together with a page of notes that I have made for your convenience [*refer attachment 2*].

I would appreciate your response to these matters as discussed to put these matters to bed as soon as possible.

Regards,

Mr White

Attachment 1

Extract from the additional assessment in respect of the 2012 year of assessment

Details	
Reference number:	123454321
Document number:	5678
Date:	2014-05-10
Year of assessment:	2012
Type of assessment:	Additional assessment
Period (days):	365
Due date:	2014-05-10
Second date:	2014-05-17

Assessment information	
Income	R21 200 000 ¹
Deductions allowed	(R800 000) ²
Taxable capital gain @ 66.6%	R2 000 000 ³
Taxable income	R22 400 000
Tax payable on adjustments after rebates	R6 272 000
Understatement penalties	R7 840 000
Section 89 <i>quat</i> interest	R1 128 960
Total tax payable in terms of additional assessment	R15 240 960

¹ Consisting of R3 million (recoupsments of sections 12C and 13 allowances), proceeds from the sale of Dust Garden shares of R17 million and fertiliser sales of R1,2 million.

² Consisting of the purchase price and commission for fertiliser.

³ Consisting of a reversal of the R7 million capital gain on the sale of Dust Garden shares and inclusion of R10 million capital gain in respect of the building transferred to New Garden.

Attachment 2

Extracts from the annual financial statements for the 2014 year of assessment

Extract from **THE DIRECTORS REPORT**

“Message to users and prospective investors from Mr Optimul, the main holder of shares and CEO of the company

Green Garden is an established company in the business of selling products that assist farmers and avid gardeners in ensuring their crops and/or plants in the gardens grow and last optimally. The products sold range from fertilisers, compost to specially formulated powders and liquids.

The business model of the company is to outsource all functions relating to the business and only perform the functions of taking delivery of the product until the sale takes place and selling the product itself from its building in Magaliesburg. This business model of outsourcing functions such as transport, procurement and compliant handling, has proved to be a winning formula in the past.

During the 2014 year, Green Garden has added the function of vacuum packaging the products in order to ensure that no quality gets lost during the period that products are stored before sale. This activity can be conducted from a room equipped for this purpose in the building that the company has owned since 2002. We expect that the modest investment of R4 million to acquire the vacuum packing equipment will reap handsome benefits in the foreseeable future. This trend is already visible in the rapidly growing revenues earned during the 2014 year.

The performance over the past two years has also indicated that selling the manufacturing activities to a 70%-owned subsidiary NewGard, which is an empowered entity, and disposing of investments that divert our attention from the real business, such as the one acquired in Dust Garden a few years ago, has demonstrated excellent strategic vision by management.

It is with sadness that I announce that over the past year for which the results are reported, I have taken the decision to relocate to the Isle of Man. As a result of this decision, I have spent a significant number of days abroad. This will gradually increase until I spend all of my time there and perform limited functions for Green Garden on a distance basis from the Isle of Man.

In light of the above, the two existing holders of shares, myself (60%) and Mr White (40%), who holds office as the financial director, have taken the decision to expand the investor base by the issue of shares into the market within the next 12 months. We are proud to provide others with an opportunity to share in our success as reflected in the 2014 financial statements and ensure succession of our legacy as our direct involvement reduce.

Regards,

Mr P Optimul

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDING 28 FEBRUARY 2014

		2014	2013
	Note	R	R
Revenue	1	60 000 000,00	35 000 000,00
Cost of sales		-30 000 000,00	-15 000 000,00
Gross profit		30 000 000,00	20 000 000,00
Operating costs	2	-28 000 000,00	-18 000 000,00
Profit before tax		2 000 000,00	2 000 000,00
Tax expense	3	-560 000,00	-560 000,00
Profit after tax		1 440 000,00	1 440 000,00

Extract from **ACCOUNTING POLICIES**

“Property, plant and equipment

Property, plant and equipment consist of assets held by the entity for own use, rather than for the purpose of earning investment income from it. Items of property, plant and equipment are measured at cost when initially recognised and thereafter at cost less accumulated depreciation and impairment (if any).

The useful lives of the items of property, plant and equipment have been aligned with the depreciation rate used for tax purposes. Assets are depreciated on a straight-line basis over their useful lives. The useful lives of the respective items are:

Luxury vehicles	5 years
Vacuum packaging machines	4 years
Building	20 years

Extract from **NOTES TO THE FINANCIAL STATEMENTS**

2. Operating costs

Operating costs include the following significant items:

	R
- Auditor’s remuneration	200 000
- Salaries (directors and staff)	6 000 000
- Depreciation: Luxury vehicles	900 000
- Depreciation: Vacuum packing equipment	1 000 000
- Depreciation: Building	300 000
- Indirect sub-contractor costs (transport)	10 000 000
- Management fees	8 000 000

28. Related party transactions

The company’s related parties consist of:

- Directors, as key management staff members;
- Holders of shares, Mr Optimul and Mr White.

Transactions with related parties during the year

Management fees	(8 000 000)
-----------------	-------------

The management fees are consideration paid to the Optimul Family Trust, which has been established in the Isle of Man, for services provided by Mr Optimul on behalf of the trust to Green Garden. All

members of the Optimul family, including Mr Optimul, are discretionary beneficiaries of the trust.

Required	Suggested time (270 minutes)
<p>a Assist Green Garden in disputing the additional assessment (refer attachment 1). Your assistance must include drafting the relevant correspondence (to the extent possible from the information provided) to be send to the SARS by Green Garden. You are also required to draft correspondence with Mr White to be sent with the draft correspondence that will enable Green Garden to finalise the correspondence and submit it as soon as possible.</p> <p>You are not required to complete any forms. You must however indicate which forms need to be completed in order to assist the accountant of Green Garden in this regard.</p>	101
<p>b After your meeting with Mr White, he was informed by his personal assistant that the VAT concerns have been added an as urgent matter to the agenda of the board meeting that will be taking place the next day.</p> <p>He requested you to prepare a quick half-pager in an email with your assessment of their concern and exposure as well as the action(s) that you advise that he can add to the board pack for this meeting. Given that you are keen to win Green Garden as a client, you have already indicated in an email to him that you will send your views to him before the board meeting. You are required to draft your correspondence with Mr White to meet his request.</p>	59

<p>c</p>	<p>Mr White has indicated that in the long-run Green Garden needs to ensure that its tax affairs are in order to avoid any further costs and potential reputational risk it may suffer if its annual financial statements were to disclose tax disputes and penalties on a regular basis.</p> <p>He has requested that you perform a tax risk review on:</p> <ul style="list-style-type: none"> (1) the statement of profit or loss and other comprehensive income for the year ended 28 February 2014; (2) selected notes to the financial statements; and (3) other commentary included in the company's annual report <p>which was forwarded to you (refer attachment 2). You have been requested to prepare a report detailing your findings of potential tax risks that Green Garden may be exposed to as well recommended actions to address such concerns. He has indicated that any value you can add to the business will be much appreciated.</p>	<p>110</p>
----------	--	------------