Tax Professional

Final Integrated Summative Assessment

2014 Sample Paper

Paper 2: Solution

South African Institute of Tax Professionals

PART A

Proposed objection letter

Dated

Addressed to SARS/Commissioner

To whom it may concern

This document sets out our request to allow an objection submitted beyond the period prescribed by in Rule 7 as well as our grounds for objecting against the assessment issued to Green Garden Limited (Tax reference number: 123454321) dated 10 May 2014.

Request to consider late objection

- We request that this objection be considered despite the fact that it is submitted later than 30 days from 10 May 2014 when the assessment in question was issued. This request is made on the grounds that exceptional circumstances, as contemplated in section 104(5)(a) of the Tax Administration Act, exists, in which case a senior SARS official may allow the objection period to be extended beyond 51 business days (30 days and 21 days referred to in section 104(5)(a)).
- The reason for the late objection is that the taxpayer has changed tax advisors and involved the specialists to assist due to the technical and complex nature of the issues in question. Such a change in tax advisors constitutes an activity outside the ordinary activities of Green Garden. Such a factor is considered to be extraordinary in terms of Interpretation Note 15.

Grounds of objection

- BEE transaction

  - A compost manufacturing plant and building (acquired in 1988) that was 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 asset-for-share transaction is defined in section 42(1) as:

    "any transaction—

    - (i) in terms of which a person disposes of an asset (other than an asset which constitutes restraint of trade or personal goodwill), the market value of which is equal to or exceeds—

      - in the case of an asset held as a capital asset, the base cost of that asset on the date of that disposal; or

      - in the case of an asset held as trading stock, the amount taken into account in respect of that asset in terms of section 11 (a) or 22 (1) or (2),

    to a company which is a resident, in exchange for the issue of an equity share in that company and that person—

    - at the close of the day on which that asset is disposed of, holds a qualifying interest in that company; or
    - is a natural person who will be engaged on a full-time basis in the business of that company, or a controlled group company in relation to that company, of rendering a service; and

(i) as a result of which that company acquires that asset from that person—

- as trading stock, where that person holds it as trading stock;
- as a capital asset, where that person holds it as a capital asset; or
- as trading stock, where that person holds it as a capital asset and that company and that person do not form part of the same group of companies:

Provided that this subparagraph does not apply in respect of any transaction which meets the requirements of subparagraph (i) in terms of which a person disposes of an equity share in a listed company or in a portfolio of a collective investment scheme in securities to any other company …"

- If a transaction meets this definition, the roll-over relief in section 42 applies unless the parties to the transaction elect in writing that it should not apply.

- Green Garden disposed on assets (plant and building). The market value of these assets, as per the attached valuation report, exceed the base costs, as determined in accordance with paragraph 20 of the Eighth Schedule (refer calculation attached). NewGard is a resident company. NewGard issued shares to Green Garden as consideration for the disposal of the assets.

- As a result of the share issue Green Garden acquired a 100% interest, which subsequently reduced to 70%. In all instances, Green Garden would however have a qualifying interest in NewGard as it holds more than 10% of the equity shares, as required by para (c) of the definition of 'qualifying interest' in section 42(1).

- NewGard acquired the assets to continue the operations previously carried on by Green Garden. As such, the nature of the assets remained unchanged and are still capital assets in the hands of NewGard.

- It is submitted that the transaction meets the definition of an asset-for-share transaction in section 42 and therefore qualifies for the roll-over treatment in terms of this section.

- Section 42(2) deems Green Garden to have disposed of the assets to NewGard at their base costs. As a result no capital gains arise. On this ground, we object to the capital gain of R10 million included in taxable income on the disposal.

- Section 42(3)(a)(i) similarly disregards any recoupment in the hands of Green Garden and deems Green Garden and NewGard to be the same person in respect of allowances on the asset. On this ground, we object to the recoupment of R3 million which has been included in taxable income.

Sale of Dust Garden shares

- The definition of gross income excludes any amount of a capital nature that is received or that accrues to a taxpayer. If such amount is received on the disposal of an asset, it may be included in proceeds for purposes of determining a capital gain or loss on the disposal of the asset.
- It has been held in a number of cases, including Overseas Trust Corporation Ltd v CIR and Lace Proprietary Mines Ltd v CIR, that an amount will not be of a capital nature if it is received as part of a scheme of profit-making by a taxpayer.
- It was held in cases such as Natal Estates Ltd v SIR and Elandsheuwel Farming (Edms) Bpk v SBI if an asset was acquired with the intention to hold the asset and derive benefits from such an asset from using the asset, rather than re-selling it, the proceeds on disposal could be considered to be capital in nature.
- It was furthermore held in the cases of Natal Estates Ltd v SIR and CIR v Stott that the taxpayer's intention with an asset must be considered at the time of acquisition. This intention may change. Such a change in intention from a capital asset at initial acquisition to become an asset used in a scheme of profit-making requires the taxpayer to cross the Rubicon.

- It was held in cases such as John Bell & Co (Pty) Ltd v SIR and CIR v Stott that a taxpayer can realise a capital asset at its best advantage without necessarily changing the nature of the asset.
- The initial intention of Green Garden with the acquisition of the Dust Garden shares was to revive the business of Dust Garden in the long-run. It is submitted that this intention indicates that these shares were capital in nature. Please refer to correspondence and agreements to this effect.
- When the opportunity arose Green Garden did however dispose of the shares for a profit. Green Garden did not actively seek such opportunities. It is submitted that in line with the case law referred to in 3.2.5., this disposal merely represents a realisation of a capital asset, rather than a change in intention that crosses the Rubicon into a scheme of profit-making.
- The judgment in the recent case of Capstone 556 (Pty) Ltd v C:SARS is based on a similar fact to those of Green Garden and supports the above line of argument.
- On these grounds we object to the treatment of the amount of R17 million being treated as gross income for Green Garden.

Imposition of understatement penalties

- As an alternative ground of objection, should the above objections not be successful.
- It appears as if understatement penalties have been imposed at a rate of 125%, which suggests that SARS was of the view that Green Garden acted with gross negligence and was obstructive or is a repeat case.
- It is submitted that Green Garden acted with regard to the legislation and had grounds for taking the tax positions, as set out above. Based on this, the taxpayer's behaviour does not fall into categories (iv) or (iii) of the table in section 223 of the Tax Administration Act.
- The taxpayer furthermore implemented a number of processes, such as appointing auditors who reviewed tax calculations, to ensure that tax returns are completed as

best possible. It is therefore submitted that the taxpayer's behaviour does not fall into category (ii) of the table in section 223 of the Tax Administration Act.

- Lastly, a substantial understatement is defined in section 221 as a prejudice to the fiscus exceeding the greater of R1 million or 5% of the tax properly payable by the taxpayer. Section 222 was amended at the end of 2013 to clarify that the table in section 223 should be applied to each understatement/shortfall. It is therefore submitted that the following shortfalls do not exceed the thresholds and would not give rise to a substantial understatement:
  - Understatement of taxable income from fertilizer sales (R400 000 x 28%)
- A repeat case is defined in section 221 of the Tax Administration Act as "a second or further case of any of the behaviours listed under items (i) to (v) of the understatement penalty percentage table reflected in section 223 within five years of the previous case". It is submitted that the presented additional assessment and potential behaviour of the taxpayer is the first such instance. The penalty, if any, should therefore be imposed as a standard case, rather than a repeat case/obstructive taxpayer.

Interest charged in terms of section 89quat

- Based on the above grounds of objection to the items giving rise to the tax debt in respect of which the interest is charged, we object to the imposition of the interest.
- We will receive your decision in respect of the above request and objection at the following address:

  xxx

  xxx

  xxx
- Please feel free to contact us if you require any further information or documentation.

Yours sincerely

Tax Specialist.

Proposed email to client

Dear Mr White

Based on the information presented to me and our discussions during the meeting, the following points are relevant to dispute the assessments in question:

- The period that has passed since the date of the assessment (10 May to 16 September 2014) exceeds the 30 day period as well as 45 additional days that Green Grass would have had to request reasons for the assessment in terms of Rule 6.
- The action available to Green Garden would therefore be to object to the assessment, with a request for the Commissioner to consider the late objection given that the objection will only be submitted in September, which is more than 30 days from the date of assessment.
- As the objection relates to corporate income tax, the NOO form needs to be completed.
- The dispute resolution rules require that further supporting documentation be submitted with the objection. In my view, the following information needs to be submitted with the objection:
- Attach the valuation report as well as a detailed calculation of the base cost of the plant and building.
- Correspondence and agreements that indicate the intention of Green Garden to acquire the Dust Garden shares to revive the business.

Please let me know if you have any further questions.

Regards

Tax Specialist.

PART B

Note / Report / Similar document

Subject: Response to VAT concerns

Dear Mr White

This document sets out my preliminary views on the information presented to me on 16 September 2014. I would require more detailed information to be able to give you formal advice on the matters at hand. Please find below my summarised views as well as explanations for my preliminary and initial views:

Summary of views

- The sale of fertilizers does not qualify for the zero-rating as Green Garden does not have documentation to prove that it was sold to bona fide farmers.
- I would not be willing to assist, be involved or support any proposal to provide false information to SARS. This behaviour would constitute a criminal offence for yourselves if the advice is followed.
- If the exclusions were to be identified by SARS the consequences may be the raising of an additional assessment (possibly without the 5 year limit being applicable), understatement penalties as well as interest and penalties for the late VAT payment.
- The above understatement penalties can be prevented if a VDP application is submitted. This would however mean that the tax would be payable by Green Garden.

Zero-rating applicable to agricultural products

- Green Garden is a VAT vendor. As such, any goods or services supplied by Green Garden in the course of the enterprise carried on by it would be subject to VAT at a rate of 14% unless a zero-rating in section 11 of the VAT Act or an exemption in section 12 of the VAT Act applies. In this case, the question is whether the zero-rating in section 11(1)(g) may be applied.

- Section 11(3) of the VAT requires that certain documentation must be retained by a vendor in order to zero-rate supplies. If such documentation is not kept, the supply would be subject to tax at 14%.
- This zero-rating applies where: “the supply is of such goods used or consumed for agricultural, pastoral or other farming purposes as are set forth in Part A of Schedule 2, provided such supply is made in compliance with such conditions as may be prescribed in the said Part”. Part A of Schedule 2 requires that the zero-rating will only apply if: “the Commissioner, in respect of a vendor registered under this Act, is satisfied that that vendor, being the recipient of any such goods, carries on agricultural, pastoral or other farming operations and has issued to him a notice of registration in which authorization is granted whereby the goods concerned may be supplied to him at the rate of zero per cent: Provided that where a vendor to whom such notice of registration has been issued is in default in respect of his obligation under this Act to furnish any return or to pay tax or he has ceased to carry on the said operations or he has utilized such notice of registration for purposes other than the carrying on of such operations, the Commissioner may, by notice in writing to the vendor, cancel such authorization with immediate effect or with effect from a date determined by the Commissioner and require the vendor to surrender such notice of registration in order that an amended notice of registration, excluding the said authorization, may if necessary be issued to the vendor”. The zero-rating can therefore only be applied if the goods are sold to a bona fide farmer who provides the supplier with a document where the Commissioner has approved this fact.
- As Green Garden has not obtained such documents/certificates from its clients, the supplies would in my view not qualify for the zero-rating in terms of section 11(1)(g).

Agent relationship proposal

- As a registered tax practitioner under section 240 of the Tax Administration Act I would not support or assist the fabrication of an agency agreement in any way as such action could compromise my position as tax practitioner. I would also like to make you aware that this action (providing false answers or information to SARS)

may constitute a criminal offence that may lead to a fine and/or imprisonment under section 235(1)(b) of the Tax Administration Act.

Exposure to risks

- SARS may raise an additional assessment for the VAT should they identify this understatement of output tax. As negligent non-disclosure caused the underpayment of VAT, it is submitted that SARS would not be limited by section 99 of the Tax Administration Act to only correct these assessments for a period of 5 years from the date of assessment (when the return was submitted – refer section 90 of the Tax Administration Act.
- As VAT was not paid due to an omission from a return(s), an understatement that caused prejudice to SARS (too little VAT collected) occurred. SARS may impose understatement penalties in terms of section 222 of the Tax Administration Act.
- Given that the understatement occurred due to gross negligence and on a repetitive basis, the understatement penalties may be imposed at a rate as high as 125% in terms of section 223 of the Tax Administration Act.
- If the additional assessments were to be raised, a further 10% percentage based penalty for late payment as well as interest would be imposed under section 39 of the VAT Act.

Measures to address risks

- The risk of additional assessments as well as interest and percentage based penalty under section 39 of the VAT Act can in my view not be reduced.
- The risk of understatement penalties can be addressed as follows:
  - In respect of returns submitted before 1 October 2012, section 270(6D) of the Tax Administration Act requires that the Commissioner must remit the penalty if the behaviour of the taxpayer that caused the understatement was not to evade tax. Green Grass should have grounds to request remittance of penalties on pre-1 October 2012 returns on this basis.

- In respect of all returns, the understatement penalties applicable under section 223 can be reduced if Green Grass applied for voluntary disclosure relief. This relief would however not apply to any interest or the 10% penalty for late payment. You would also still be required to pay the VAT that was not declared.

PART C

18 August 2015

Dear Mr White

Report on the tax review conducted in respect of Green Garden

Scope of the review and indemnification

- You have requested that we conduct a tax review in respect of Green Garden. The review covers the income tax, value added tax and employment related tax compliance of the entity. The purpose of such this review was to identify the tax compliance risks as well as opportunities to conduct or structure the business in a more tax efficient manner in principle. This report sets out the findings and recommendations arising from this review. Please note that the report does not address any accounting, regulatory aspects or taxes other than those listed above. In addition, the report does not cover any persons, other than identified above.

- As the review was conducted based on information that you have provided to us, no responsibility is accepted for the accuracy of this information. This information has not been audited or verified in any manner. Any reference to such information is made to illustrate and support the principle identified as a tax compliance risk or opportunity to conduct activities in a more tax efficient manner. Reference to such information should not be construed as assurance that such information is accurate, correct or complete. In addition, a reference to specific information for purposes of illustrating or supporting a finding does not provide any assurance that the instance(s) referred to is the only of its nature. It is advised that a detailed investigation be conducted by the entity to identify all instances affected by the findings and recommendation in this report.

- The findings and recommendations reported in this document are based on our and interpretation of the relevant tax legislation and case law as well as practice. In addition, these are the results of review procedures performed by us to identify the tax compliance risks and opportunities to structure or conduct activities in a more tax

efficient manner. The findings and recommendations of a review conducted by other accountants, auditors or the tax authorities may differ from ours. As a detailed audit was not conducted in respect of all tax calculations and tax returns, this report does not provide assurance as to the correctness of all tax calculations and tax returns that may have been examined during the review procedures.

- The views expressed in this report are based on our knowledge and interpretation of the relevant tax legislation, case law and practices as referred to in the discussion. These principles may change over time as a result of amendments, case law and other circumstances. Such changes may impact on the findings and/or principles discussed in this report. We do not undertake to inform you of the impact of any such changes on the views expressed in this document.

- The views expressed in this report are our views based on our and interpretation of the relevant tax legislation and case law as well as practice. The views of and interpretation of the relevant legislation and case law by other accountants, auditors or the tax authorities may differ from ours. Although our directors, employees and subcontractors perform their duties with the utmost diligence and with reasonable care, this document does not provide assurance that the views expressed herein will not be queried by any party, or that the views will be upheld by the tax authorities in the event where action is taken in accordance with the views expressed in this note. The purpose of this document is therefore to provide you with findings and recommendations to consider implementing in the entity in respect of which the review was conducted.

- The liability our firm, its shareholders, directors, employees and agents, in respect of any claims arising from this document is limited to twice the fees charged.

- This document is intended solely to provide views on principle in general for the benefit, information and use by Green Grass Limited. It should not be distributed to third parties without our prior written consent. We do not accept responsibility for a third party who relies on this note.

Information considered

- In performing the review, the following resources were used:
  - Extracts from the financial statements of Green Grass for the year ending 28 February 2014. It should be noted that this was not a full set of financial statements. A full set of financial statements may highlight further risks. It is recommended that a review of such a full set of financial statements be performed to identify all aspects to be considered by you.
  - Aspects of your business relating to previous periods and addressed in other reports have not been repeated in this document. This document only contains information from the review of the financial statements.

Income tax review

- Correlation between the performance of the company and its tax liability
  - We have noted that the financial statements refer to success of the company during the 2014 financial year. This success is however not reflected by the profit before tax and tax expense that remains unchanged from the 2013 to 2014 years of assessment.
  - The success of the company creates an expectation of increased profits and tax on such profits. The overall results of the company are therefore not aligned with the descriptive information in the directors' report. We would encourage you to investigate the reasons for the contradictory information, as this contradiction may trigger risk assessment indicators at SARS.
- Wear and tear deductions in respect of luxury vehicles
  - An amount of R900 000 of wear and tear allowances appear to be claimed in respect of luxury vehicles based on the alignment between accounting and tax depreciation.

- We are unable to understand the use of the luxury vehicles in Green Garden's trade.
- Section 11(e) allows a wear and tear allowance in respect of "any machinery, plant, implements, utensils and articles …used by the taxpayer for the purpose of his or her trade".
- If the luxury vehicles are not used for purposes of Green Garden's trade, the wear and tear allowances may not be allowed as a deduction.

- Allowances on vacuum packing equipment
  - From the accounting policy notes on the depreciation rate for vacuum packing equipment it appears as if the allowances on the equipment are deducted in terms of section 11(e).
  - Section 12C however provides an accelerated allowance in respect of "machinery or plant … owned by the taxpayer … which was or is brought into use for the first time by the taxpayer for the purposes of the taxpayer's trade (other than mining or farming) and is used by the taxpayer directly in a process of manufacture carried on by the taxpayer or any other process carried on by the taxpayer which in the opinion of the Commissioner is of a similar nature".
  - Practice Note 42 lists certain processes viewed by SARS as being similar to manufacturing. It specifically lists vacuum packing.
  - Green Garden can therefore claim the accelerated section 12C allowances in respect of the vacuum packing equipment.
- Allowances on building
  - It appears as if depreciation has been deducted in respect of the building for tax purposes (as tax and accounting treatment aligned).
  - As the building is not mainly used for a process of manufacturing (vacuum packing – refer above), this building does not qualify for section 13 allowances.

- As the building was acquired before 1 April 2007, it does also not qualify for allowances in terms of section 13quin.
- It therefore appears as if the building does not qualify for any tax allowances and the depreciation deduction may be contrary to the Income Tax Act.

- Management fees paid to the Optimul Family Trust
  - As a beneficiary of the Optimul Family Trust, Mr. Optimul is a connected person in relation to the trust (refer definition of 'connected person' in section 1 of the Income Tax Act). As shareholder holding more than 20% of the shares of Green Garden, Mr Optimul and Green Garden are connected persons in relation to each other (refer definition of 'connected person' in section 1 of the Income Tax Act). In terms of paragraph (b)(ii) of the definition of 'connected person' as trust is also connected to a connected person in relation to a beneficiary. As such, Green Garden and the Optimul Family Trust are connected persons in relation to each other.
  - It is our understanding that the trust is effectively managed from the Isle of Man. If this is the case, the trust is not a resident of South Africa for tax purposes. If the fee charged to Green Garden by the Trust is not an arm's length fee, Green Garden may obtain a tax benefit from this in the form of an excessive deduction. In such a case, the taxable income of Green Garden must be determined as if an arm's length fee was paid to the Optimul Trust.
  - It should be noted that this fee may be subject to a withholding tax on service fees from January 2016.

Value-added tax review

- Use of luxury vehicles
  - As indicated below in the employees' tax findings, a fringe benefit may exist if the vehicles are used by employees for private purposes.
  - Section 18(3) of the VAT Act deems as supply to take place if the right to use a vehicle is given to an employee.
  - Green Garden would be required to pay output tax on such a supply to SARS.

Employment related tax review

- Use of luxury vehicles
  - An amount of R900 000 of wear and tear allowances appear to be claimed in respect of luxury vehicles based on the alignment between accounting and tax depreciation.
  - We are unable to understand the use of the luxury vehicles in Green Garden's trade.
  - Paragraph 2(b) of the Seventh Schedule deems a fringe benefit to arise where an employee has the right to use a vehicle.
  - In terms of paragraph 7 of the Seventh Schedule, the value to be placed on such a vehicle is 3,5% of the determined value if the vehicle does not have a maintenance plan and 3,25% if the vehicle has a maintenance plan. The value of the fringe benefit is however reduced to the extent that the vehicle is used for business purposes.

- If the vehicle is used for private purposes by an employee, a fringe benefit arises. 80% of this fringe benefit is included in the employee's remuneration (refer to the definition of 'remuneration' in paragraph 1 of the Fourth Schedule to the Income Tax Act). Green Grass may be liable to withhold employees' tax on such remuneration. Failure to withhold such employees' tax could result in Green Grass being liable for this tax.

- If the benefit is not derived by virtue of employment, but rather by reason of shareholding, the benefit would constitute a dividend. It was held in the case of C: SARS v Brummeria Renaissance & Others that any benefit with a monetary value would be an amount. A dividend is defined as "any amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company". Such a dividend would be subject to dividends tax at a rate of 15%. As this would be a non-cash dividend, it is a dividend in specie. Green Grass would in this case be liable for the dividends tax.

- Management fees paid to the Optimul Family Trust

  - The services for which the Optimul Family Trust receive the fee are rendered by Mr Optimul.

  - Paragraph (c) of the definition of gross income specifically provides that: "any amount received by or accrued to or for the benefit of any person in respect of services rendered or to be rendered by any other person shall for the purposes of this definition be deemed to have been received by or to have accrued to the said other person".

  - This may result in Mr Optimul being subject to tax on this income. If this is the case, the fee may be viewed as remuneration, given his position as director at Green Garden, in which case Green Garden would have to withhold employees' tax on the fee.

- A personal service provider is defined in paragraph 1 of the Fourth Schedule to the Income Tax Act as: “any company or trust, where any service rendered on behalf of such company or trust to a client of such company or trust is rendered personally by any person who is a connected person in relation to such company or trust”. As the services are rendered by Mr. Optimul personally, the Optimul Family Trust may be a personal service provider. A more detailed analysis and information would be required to confirm this.
- A similar risk would also exist from the perspective that the Optimul Family Trust may constitute a personal service provider and that Green Garden would be required to withhold employees’ tax from such fee payments.

Effect of risks identified

The risks identified in this report may result in understatement penalties under section 223 of the Tax Administration Act, underestimation penalties under paragraph 20 of the Fourth Schedule to the Income Tax Act as well as penalties for late payment of VAT and provisional tax should these risks be valid and assessment be raised by SARS following enquiries or audits.

Concluding thoughts

If you have any questions on the views expressed or would like to discuss the implications of the assumptions that we have made in our views you are welcome to contact us to do so.

Thank you for engaging us to conduct this work.

Yours faithfully,

Tax Specialist

(Tax Practitioner Number: 123456789)