

PAPER 3 MEMO

		CANDIDATE NUMBER		
No	Aspect of the Answer	Marks	Candidate Mark Obtained	Sub Total
1	To Mr. Anil Naidoo From Tax Manager Subject Tax implications of issues discussed Date 14 December 2017	0.5		
	Scope We refer to our meeting held on 13 December 2017. We were requested to advise you, Mr. Anil Naidoo, on the tax implications of the following issues that were discussed at our meeting: Issue1: Restraint of trade payment Issue 2: Interest paid Where applicable, we mention any potential tax risk that we have identified relating to the above issues and our review of the ITA34 Additional Assessment. We also address tax compliance matters that should be considered by you. We furthermore provide recommendations on how you should address the above tax issues.	0.5		
	Limitation of liability Our advice is based on the information provided by you. We have not audited the information provided to us. We therefore do not provide any assurance regarding the completeness and accuracy of the information provided to us. Our advice is based on the current legislation as contained in the Income Tax Act No. 58 of 1962 (the Act). These principles are subject to change occasioned by future legislative amendments and court decisions. Such changes may impact on the advice given. You are cautioned to keep abreast of such developments and are welcome to engage our services again for this purpose. You are responsible for your tax returns and the declarations that you make to the South African Revenue Service (SARS). Etc.	0.5		
General points to note				
ELO1	ITR12 tax return deadlines The tax season for non-provisional taxpayers closed on 24 November 2017. The 2017 tax return deadline for provisional taxpayers is 31 January 2018. <u>As you are registered as a provisional taxpayer (due to the fact that you earn business income), you are only</u>	1		

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	<p><u>required to submit your 2017 tax return on or before 31 January 2018.</u></p> <p>We recommend that you ensure that your ITR12 tax return is reviewed by a tax practitioner (with more experience in personal income tax) before submission to SARS.</p> <p>We will gladly assist you in reviewing your future tax returns if you so wish.</p>			
ELO3	<p>Onus of proof In terms of section 102 of the Tax Administration Act, the onus of proof is on the taxpayer to prove that an amount is deductible.</p> <p>You will therefore have to proof in terms of the Act that the restraint of trade payment and the interest paid are deductible and you will be required to submit supporting documents.</p>	1		
	SUBTOTAL: 4			
<u>Issue 1: Restraint of trade payment</u>				
	<i>Tax Implications: Income Tax</i>			
ELO4	- In terms of s23B(3) , no deduction may be allowed under s11(a) where a deduction or allowance may be granted under a specific provision.	0.5		
ELO4	- Restraint of trade payments are deductible under s11(cA) and not s11(a)	1		
ELO4	- In terms of s11(cA) an allowance in respect of any amount incurred by a person in the course of carrying on a trade, paid as compensation in respect of restraint of trade imposed on a person that is a natural person , may be deducted to the extent that the amount will constitute income to the person paid.	1		
ELO4	- In terms of para (cB) of the gross income definition, an amount received by a natural person for a restraint of trade imposed on that person due to the person's <ul style="list-style-type: none"> o Employment or o Any past or future employment Should be included in the person's gross income	1		
ELO4	- Therefore, New Packaging Enterprises, would be able to claim a deduction under s11(cA), as the restraint of trade payment is made to Kelly Newton, who is a natural person , and the amount paid constitutes income in the hands of Kelly Newton as it should be	1 1		

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	included in Kelly Newton's gross income in terms of para (cB)			
ELO1 &4	<ul style="list-style-type: none"> - In terms of s11(cA)(iv) the deduction for the 2017 year of assessment would be the lesser of : - R3 000 000/4 (no apportionment) or R3 000 000/3 	1		
ELO1 &4	<ul style="list-style-type: none"> - Therefore, the deduction in terms of s11(cA) for the restraint of trade for New Packaging Enterprises is R750 000 for the 2017 year of assessment. 	1		
	<i>Tax Implications: Employees' Tax</i>			
ELO4	<ul style="list-style-type: none"> - Payments made in respect of a restraint of trade (i.e. sterilisation of a person's income earning capacity) to any natural person is included in the definition of remuneration if the restraint of trade payment relates to: <ul style="list-style-type: none"> o Employment or the holding of any office; or o Any past or future employment or the holding of an office. - Remuneration definition in paragraph 1 of the Fourth Schedule - Paragraph (cB) of the definition of gross income in Section 1 - The restraint of trade payment made to Kelly Newton will constitute remuneration for Kelly. 	1		
ELO4	<ul style="list-style-type: none"> - Paragraph 2 of the Fourth Schedule to the Act, imposes upon the employer the obligation to deduct and pay over employees' tax. - As an employer, you Mr. Naidoo trading as NPE, was required to withheld employees' tax on the restraint of trade payment made to Kelly Newton. 	1		
ELO3	<ul style="list-style-type: none"> - As no employees' tax was withheld from the restraint of trade payment, SARS may raise a PAYE assessment for NPE in respect of the PAYE and SDL that should have been withheld on the restraint of trade payment (assuming that Kelly's income is above the UIF limit, no further UIF will be payable) 	1		
ELO3	<ul style="list-style-type: none"> - In addition, SARS will levy interest and a 10% penalty on the late payment of the additional PAYE and SDL. - Para 6 of Fourth Schedule to the Act and Percentage based penalty i.t.o Chapter 15 of Tax Administration Act (TAA) 	1		
ELO3&4	<ul style="list-style-type: none"> - You, trading as NPE, can on application on the prescribed form and manner, if NPE is satisfied that there is a reasonable prospect of ultimately recovering the tax from the employee, be absolved from the employer's liability if the failure was not due to an intent to 	1		

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	<p>postpone the payment of tax or to evade the obligation of the employer (par 5(2) of the Fourth Schedule</p> <ul style="list-style-type: none"> - However, practically, Kelly Newton was supposed to submit her 2017 tax return by 24 November 2017. The chances of her refunding the employees' tax to NPE if she has already paid the income tax on the restraint of trade income, are therefore slim. 	1		
ELO4	<ul style="list-style-type: none"> - Please note that any employees' tax paid by an employer and not recovered from the employee will be deemed to be a penalty paid in terms of section 23(d) of the Income Tax Act which will not be deductible for income tax purposes. 	1		
	Recommendations			
ELO3	<ul style="list-style-type: none"> - The ITR12 tax return does not have a specific block under the section "Local Business, Trade and Professional Income" for Restraint of trade payments made in terms of section 11(cA). You have also not submitted the restraint of trade agreement to SARS during the SARS verification process. SARS therefore automatically assumed that you claimed the restraint of trade payment under section 11(a) of the Act. - In respect of your 2017 ITR12 return submitted, we recommend that you object to the disallowance of the restraint of trade payment. - The objections should be completed on a Notice of Objection form (NOO) within 30 days from the date of the assessment. - We recommend that a separate letter is drafted that sets out the grounds of objection which is then attached to the NOO form. 	0.5 0.5 0.5		
ELO3	<ul style="list-style-type: none"> - To support the deduction of the restraint of trade payment, you should provide SARS with a copy of the restraint of trade agreement. - If the agreement makes reference to the fact that the restraint of trade payment should be included in Kelly's gross income for income tax purposes, it will strengthen your arguments for a s11(cA) deduction. - Unfortunately, you will not be able to proof that employees' tax was withheld on the restraint of trade payment. 	1 0.5 0.5		
ELO3	<ul style="list-style-type: none"> - We furthermore recommend that you submit a Voluntary Disclosure application (VDP01) in respect of the employees' tax that was not withheld from the payment made to Kelly Newton. - If SARS allows the VDP01, it will minimise the possible understatement penalties that SARS may impose in terms of section 223 of the TAA on the omission from a EMP201 return and the 	1 1		

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	<p>failure to pay the correct amount of the employees' tax in relation to the restraint of trade payment.</p> <ul style="list-style-type: none"> - Note that it will not absolve you, trading as NPE, from your liability to pay the 10% under payment penalty (percentage based penalty). - You, trading as NPE, will still be required to pay the employees' tax that should have been withheld from the restraint of trade payment made to Kelly Newton. - In respect of your ITR12 tax return calculation, keep in mind that you will not be able to deduct the employees' tax paid to SARS in relation to the restraint of trade payment if you were not able to recover the employees' tax from Kelly Newton. This employees' tax will be regarded as a penalty paid to SARS which is not deductible in terms of s23(d) of the Act. It should be added back under "Other Adjustments" on the ITR12 tax return in the tax year when the "penalty" is paid to SARS. 	1		
		1		
		1		
ELO1	- For future reference, restraint of trade payments should be reflected under code 3613 on the employee's IRP 5 tax certificate	0.5		
	SUB TOTAL :25			
<u>Issue 2: Interest paid</u>				
	<i>Tax Implications: Income Tax</i>			
ELO4	In terms of s23B(3) , no deduction may be allowed under s11(a) where a deduction or allowance may be granted under a specific provision.	0.5		
ELO4	S24J(2) provides that any person who is the issuer in relation to an instrument, is deemed to have incurred an amount of interest which must be deducted from the income of that person derived from carrying on any trade , if that amount is incurred in the production of income .	1		
ELO4	Therefore, s11(a) cannot be used as s24J(2) is applicable.	1		
ELO4	S24J(2) requires you, Mr. Naidoo to be the issuer in relation to the instrument. In this case, you are the issuer in relation to the instrument as you issued the right to pay interest and capital on the loan from SAFRICA Bank.	1		
ELO4	Further, s24J(2) requires the interest to be deducted from the income of that you, Mr. Naidoo derived from the carrying on of a trade.	0.5		
ELO4	The word " trade " is defined in s1 of the Act and includes every profession, trade, business, employment, ...etc. In <i>Burgess v CIR</i> (1993 A) it was	0.5		

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	said that the word trade should be given a wide interpretation.			
ELO4	For a taxpayer to be able to argue that it is carrying on a trade , the taxpayer will have to be able to motivate that: <ul style="list-style-type: none"> • There is a continuity of activities • The long-term objective of the trade is to generate profit 	0.5		
ELO4	Despite its wide meaning, the term “trade” does not include all activities that might produce income for example in the form of interest, dividends and annuities. Therefore, the earning of passive income does not constitute a trade.	0.5		
ELO4	In practice, SARS accepts that if capital is borrowed specifically to reinvest, such transaction results in trade income and the expenditure is therefore allowable. On this basis, interest paid in order to earn interest income is allowed as a deduction. The Commissioner’s practice is set out in Practice Note No31 and the relevant portion reads: While it is evident that a person (not being a moneylender) earning interest on capital or surplus funds invested does not carry on a trade and that any expenditure incurred in the production of such interest cannot be allowed as a deduction, it is nevertheless the practice of Inland Revenue to allow expenditure incurred in the production of interest to the extent that it does not exceed such income. The practice will also be applied in cases where funds are borrowed at a certain rate of interest and invested at a lower rate. Although, strictly in terms of the law, there is no justification for the deduction, this practice has developed over the years and will be followed by Inland Revenue.	1		
ELO4	You, Mr. Naidoo specifically borrowed money from SAFRICA Bank in your personal capacity to on lend the money to Paper Man (Pty) Ltd) in order to assist Paper Man to buy machinery. Based on the practice set by Practice Note 31 , you may be able to argue that you are carrying on a trade.	1		
ELO4	To strengthen the trade requirement, it can furthermore be argued that you, Mr. Naidoo borrowed the loan at a prime lending rate and lent it to Paper Man (Pty) Ltd at a higher interest rate, thereby making a profit which may constitutes a trade.	1		
ELO4	You may also argue that there is continuity of activities in that the loan agreements are over a 5-year period.	1		
ELO4	We however wish to caution that SARS on the other hand, may argue that you, Mr. Naidoo is not in the business of lending money (therefore not a moneylender) and is not a registered credit provider. SARS may furthermore argue that this arrangement is an once off arrangement (e.g. one loan agreement	1 1		

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	with Paper Man) in that you are not continuously lending and on lending money and is therefore not continuously carrying on a trade.			
ELO4	One also need to consider if the interest paid is incurred in the production of income. This will be the case if the interest incurred is closely connected with the income earning activity from which the expenditure arose as per the PE Electric Tramway court case .	1		
ELO4	It can therefore be said that the interest of R130 000 is incurred in the production of income as the interest paid is closely connected to the normal income earning activities of earning the R180 000 interest income . The interest income of R180 000 together with the interest from Investec of R12 500, will be exempt to the extent of R23 800 in terms of s10(1)(i) as you, Mr Naidoo is a natural person . The taxable portion of R168 700 interest constitutes income which exceeds the R130 000 interest paid , therefore no limitation of the interest paid to the interest income.	1 1 1		
ELO4	Therefore, the interest incurred on the loan of R130000 will be deductible in terms of s24J(2).	0.5		
	Recommendations			
ELO1,2 &3	- The interest paid of R130 000 was declared on the ITR12 tax return under Other Deductions (code 4016). In order to indicate to SARS that the interest paid was incurred to earn trade income, you were required to declare it under "Local Business, Trade and Professional Income".	1		
ELO3	- In respect of your 2017 ITR12 return submitted, we recommend that you object to the disallowance of the interest paid. - The objections should be completed on a Notice of Objection form (NOO) within 30 days from the date of the assessment. - We recommend that a separate letter is drafted that sets out the grounds of objection which is then attached to the NOO form.	0.5 0.5 0.5		
ELO3	- To support the deduction of the interest payment, you should provide SARS with a copy of the loan agreement between you and SAFRICA Bank and a copy of the agreement between you and Paper Man. - For future reference, it might have saved you on having to object to the disallowance of the interest expense if you have submitted the loan	1 0.5		

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	agreements with the documents uploaded for the SARS verification			
ELO1&3	<ul style="list-style-type: none"> - In the grounds of objection letter, you should explain to SARS that you should have declared two separate trading activities on your 2017 ITR12 tax return, namely one for NPE and one for Interest earning activities. - Also keep this in mind for future ITR12 tax returns that you need to complete. - Note that if when you declare the interest income under the “Local Business, Trade and Professional Income” section of the ITR12 tax return, the SARS system might not calculate the interest exemption in terms of section 10(1)(i) against it and you would then need to consider whether you wish to object against it. 	<p style="text-align: center;">1</p> <p style="text-align: center;">0.5</p> <p style="text-align: center;">0.5</p>		
<u>SUB TOTAL: 22</u>				
<u>Underestimation penalty</u>				
	<i>Tax Implications: Income Tax</i>			
ELO4	<p>On the ITA34 Additional Assessment issued to you, SARS levied an underestimation penalty in terms of para 20 of the Fourth Schedule to the Act. This is due to the fact that SARS disallowed the deductions which led to your taxable income being higher than what you have submitted to SARS as an estimate with your second provisional tax return.</p> <p>The underestimation penalty is levied when the second provisional tax estimate is less than 80% of the final taxable income as assessed. A penalty of 20% is levied on:</p> <ul style="list-style-type: none"> • Tax calculated on 80% of the assessed taxable income LESS employees’ tax and provisional tax payments. 	<p style="text-align: center;">1</p> <p style="text-align: center;">1</p>		
	<i>Recommendations</i>			
ELO3	<p>On the NOO form and in your grounds of objection supporting the NOO form, you should consider to respectfully requests that the Commissioner exercise his discretion to remit the <u>underestimation penalty imposed in terms of para20(1)(a) of the Fourth Schedule</u>, as contemplated in <u>para 20(2)</u>, taking in to account the following:</p> <ul style="list-style-type: none"> • The estimate was <u>seriously calculated with due regard to the factors having bearing thereon</u> since the provisional tax calculation took into account the <u>deduction in respect of the restraint of trade payment and the interest paid</u>, which are submitted in this letter, were correctly deducted in terms of section 11(cA) and section 24J(2) respectively. 	<p style="text-align: center;">1</p> <p style="text-align: center;">1</p>		

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	<ul style="list-style-type: none"> The estimate was <u>not deliberately negligently understated</u>. In fact, there is no difference between the taxable income per the 2017 second provisional tax return and the final 2017 ITR14. <i>[Note: The examiner may also award marks up to a maximum of 3 if the candidate applies section 217(3) of the TAA which empowers SARS to remit a penalty imposed under s213 (as is the present case)]</i> 	1		
Other points mentioned: Marks may be awarded for any valid points up to a maximum of 2 marks.		2		
	<u>SUB TOTAL:</u>	7		
	Please feel free to contact us if you have any further queries in this regard or if you require our assistance with objecting to the ITA34 Additional Assessment issued to you.			
	Format and layout: Memorandum includes client's name, date, subject line and the layout of the memo is logical and easy to follows (headings and/or numbering used where appropriate). The overall impression is professional.	0.5		
	Professional language and coherence of arguments: The language used in the memorandum is clear and concise, and achieves the aim of providing taxpayer-centred advice. The advice should be useful to the client and should not create confusion or further uncertainty. Nor should the advice contain irrelevant technical detail or unfounded views. The flow of arguments should be logical, clear and concise.	0.5		
	<u>SUB TOTAL: 1</u>			
	AVAILABLE	59		
	MAXIMUM	50		
	CANDIDATE FINAL SCORE			