

Tax Professional  
EISA Examination

November 2017

Paper 4: Solution

No.	Aspect of the answer	Marks	Candidate Mark obtained
<b>PART A</b>			
1.	<b>Objection to disallowance of foreign exchange loss in 2016 additional income tax assessment</b>		
1.1	Annexure A – calculation of forex loss (completed within excel schedule)		
	The marking of Annexure A is completed on the student’s Annexure A submission and the mark allocation is provided in the <i>Annexure A – Suggested Solution</i> which appears at the end of this document.	7	
1.2	Objection letter – objection to 2016 disallowance of the foreign exchange loss		
Relevant Law	Identification of section 24I as the relevant section of the legislation.	1	
	More specifically, in terms of <u>section 24((10A)</u> , a foreign exchange gain or loss is deferred until realisation. Section 24I(10A) applies to foreign exchange gains or losses arising between <u>connected persons</u> . However, there is no such deferral if any portion of the loan is considered a <u>current liability</u> for purposes of financial reporting pursuant to IFRS, or the loan was <u>funded directly or indirectly by a party unconnected</u> to Nebula NZL or Nebula SA, or a <u>forward exchange contract or foreign currency option contract was taken out to hedge</u> against the foreign exchange risk on the loan.	2.5	
Application	Since Nebula NZL holds 75% of the ordinary shares in Nebula SA, the two companies <u>are connected persons</u> per para (d) of the definition of ‘connected person’ in section 1. The loans in question are <u>reflected as long term liabilities</u> for financial reporting purposes pursuant to IFRS. The loans were <u>funded using Nebula NZL’s internally generated cash reserves</u> and were not funded by unconnected third parties. Finally, Nebula SA <u>did not hedge</u> against the foreign exchange risk. Therefore, the foreign exchange differences on the loans are deferred until realisation on 30 June 2016.	4	

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Calc	<p>As set out in Annexure A, the foreign exchange difference to be recognised upon realisation per section 24I(10A), is <u>calculated as</u>: the difference between the <i>ruling exchange rate on the last day of the year of assessment immediately preceding the year in which the exchange difference was realised</i>, and the <i>ruling exchange rate on transaction date</i>. Since the exchange item is a loan (debt), the <u>ruling exchange rate is the spot rate</u>. <b>[Note:</b> also accepted is the following: A further exchange difference arises in respect of the period between the <i>last day of the year of assessment immediately preceding the year in which the exchange difference was realised</i> and the <i>realisation date</i>.] Please refer to Annexure A for the supporting calculation.</p>	2	
Conclude	<p>Therefore, in <u>conclusion</u>, we submit that the foreign exchange loss of R2,781,500 was correctly calculated upon realisation (through repayment) of the loan in the 2016 year of assessment and should be deducted from Nebula SA's income in the 2016 year of assessment in accordance with section 24I(10A). We <u>respectfully request</u> that SARS allow the deduction of R2,781,500. <b>[Note:</b> Also accepted is the following: We submit that the foreign exchange loss of R2,781,500 as disclosed in the ITR14 should have been disclosed as R2,556,500 as calculated in Annexure A. In conclusion, we submit that this deduction is allowable in terms of section 24I and we <u>respectfully request</u> that SARS allow this deduction.]</p>	1.5	
Underestimation penalty	<p>The taxpayer 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"> <li>• 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 foreign exchange loss</u>, which it is submitted in this letter, was correctly determined in terms of section 24I(10A)</li> <li>• The estimate was <u>not deliberately negligently understated</u>. In fact, the only difference between the taxable income per the 2016 second provisional tax return and the final 2016 ITR14 relates to <u>unanticipated income</u> that accrued after the estimate was prepared.</li> </ul> <p><i>[Note: The examiner may also award marks up to a maximum of 5 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></p>	5	
Note:	<p>Marks awarded for other relevant comments, including arguments in relation to burden of proof (the financial manager was ill and thus it represented exceptional circumstances as to why supporting documentation was not provided).</p>		

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		<b>Available: 16 Max: 13</b>	
<b>2</b>	<b>Objection to dividends tax liability on deemed dividend in specie in relation to a shareholder loan in the 2016 year of assessment</b>		
2.1	Objection letter – objection to dividends tax assessment		
Relevant Law	In terms of <u>s64E(4)</u> , where during any year of assessment an <u>amount is owing to a company</u> by a person that is <u>not a company</u> , <u>is a resident</u> and <u>is a connected person in relation to that company</u> , the company must be <u>deemed to have paid a dividend</u> if that debt arises by virtue of any share held in the company. The dividend is deemed to be a dividend <u>in specie</u> and is <u>calculated as</u> : the difference between the <i>interest that was payable on the loan</i> and the <i>market related interest</i> .	3.5	
Application	As the shareholder loan was <u>extended to a company (Nebula NZL)</u> and since that company is <u>not a South African resident</u> for tax purposes (it is tax resident in New Zealand), the provisions of section 64E(4) do not apply to this loan.	2	
Conclusion	We, therefore, object to the dividends tax assessment reflecting a dividends tax liability of R354.75. We respectfully request that a reduced assessment be issued in order to reflect a liability of Rnil.	1	
		<b>Available: 6.5 Max: 5</b>	
	<b>Communication skills – layout, language, coherence</b>		
	<u>Format of Annexure A:</u> The supporting schedule is prepared such that it is easy to follow and clearly indicates to SARS how the foreign exchange loss was calculated.	1	
	<u>Format and layout of objection:</u> Objection is addressed to Ms Mala at SARS Large Business Centre and clearly indicates the grounds for the objection, including the relevant law and the application of the law to the facts as requested. The layout of the objection is logical and easy to follow (headings and/or numbering used where appropriate). The overall impression is professional.	1	

No.	Aspect of the answer	Marks	Candidate Mark obtained
	<u>Professional language and coherence of arguments:</u> The language used in the objection is clear and concise, and achieves the aim of providing sound arguments in order to successfully dispute the deduction / liability. The advice should be understandable to SARS and should not create confusion or further uncertainty. Nor should the objection contain irrelevant technical detail or unfounded views. The flow of arguments should be logical, clear and concise.	2	
		<b>Available: 4 Max: 4</b>	

No.	Aspect of the answer	Marks	Candidate Mark obtained
<b>PART B</b>			
<b>3.</b>	<b>Interest withholding tax implications of proposed loan from Nebula NZL</b>		
<b>3.1</b>	<b>Interest WHT implications for Nebula SA in respect of proposed loan</b>		
	Any interest paid by Nebula SA to Nebula NZL would <u>deemed to be from a SA source</u> in terms of section 9(2)(b) of the Income Tax Act No. 58 of 1962.	1	
	Therefore, the interest on the loan will be subject to interest WHT at a <u>rate of 15%</u> (s50B(1)), subject to any treaty relief.	1	
	Per Article 11 of the SA/NZL DTA, the rate is <u>reduced to 10%</u> (provided that the relevant documentation is in place).	1	
	Nebula NZL is liable for the tax, but <u>Nebula SA has the obligation to withhold the tax</u> on Nebula NZL's behalf (s50C(1) and s50E(1)).	1	

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	For the purposes of the interest WHT, the interest is <u>deemed to be paid on the earlier of payment or when it becomes due &amp; payable</u> (s50B(2)). Since the loan agreement stipulates the interest is payable <u>biannually on 30 June and 31 December respectively</u> , these are dates that the interest will be deemed to be paid for purposes of the interest WHT.	2	
3.2	<b>Compliance requirements</b>		
	In order to qualify for the reduced rate per the DTA, the <u>declaration and undertaking form</u> must be completed before the interest is due and payable (s50E(3)).	1	
	The interest WHT must be paid to SARS by <u>last day of the month following the month in which the interest is paid to Nebula NZL</u> (s50F(1)). For example, the first interest payment will be deemed to be made by 30 June 2018, and therefore the payment is due by 31 July 2018.	1	
	Nebula SA will also need to submit the <u>Return for Withholding Tax on Interest (WT002)</u> by the same <u>date</u> as set out above (e.g. by 31 July 2018 for the first interest payment). SARS also <u>requires an IT3(b)</u> for purposes of proving the amount of interest WHT paid on behalf of Nebula NZL.	2	
<b>Note:</b>	Marks awarded for other relevant comments at the discretion of the examiner.		
		<b>Available: 10 Max: 8</b>	
<b>4</b>	<b>Tax efficiency of proposed distribution to the shareholders of Nebula SA</b>		
4.1	<b>Dividends tax implications assuming <u>no election</u> to reduce CTC is made</b>		
	The distribution of R500,000 will meet the <u>definition of a 'dividend'</u> in terms of section 1 of the Act (as an amount transferred by a resident company, Nebula SA, for the benefit of any person, namely Nebula Holdings and Nebula NZL, in respect of the shares they hold in Nebula SA) <u>and for the purposes of dividends tax</u> , since the definition of 'dividend' in section 64D refers back to the section 1 definition.	1	
	Nebula Holdings and Nebula NZL would bear the <u>liability</u> for the dividends tax (if any) since it is a <u>cash dividend and they are the beneficial owners of the dividend</u> (s64EA(a))	1	
	Nebula Holdings will receive a dividend amounting to R125,000 (R500,000 x 25%). However, this <u>dividend will be exempt in terms of section 64F(1)(a)</u> since Nebula Holdings is a SA resident company. However, the <u>declaration and written undertaking</u> indicating that the dividend is exempt from dividends tax will need to be submitted by Nebula Holdings to Nebula SA by the date of payment of the dividend (if no other date is specified) – s64G(2).	2	

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	Nebula NZL will receive a dividend amounting to R375,000 (R500,000 x 75%). This dividend will be subject to <u>dividends tax at a rate of 20%</u> (s64E), subject to any treaty relief. In terms of Article 10 of the SA/NZL DTA, the <u>dividends tax rate is reduced to 5%</u> since Nebula NZL holds more than 25% of the shares (Nebula NZL holds 75% of the shares). In order for Nebula SA to apply the reduced rate, the <u>declaration and written undertaking</u> indicating that the dividend is exempt from dividends tax will need to be submitted by Nebula NZL to Nebula SA by the date of payment of the dividend (if no other date is specified) – s64G(3).	3	
	If the relief afforded by the DTA is applied, the dividends tax liability will be <u>R18,750</u> (R375,000 x 5%). The dividends tax must be paid to SARS by the <u>last day of the month following the month in which the dividend is paid to Nebula NZL</u> (s64K(1)(c)). Therefore, if the dividend is paid in January 2018 (for the purposes of section 64E(2)(a)(ii)), the dividends tax is due to SARS by 28 February 2018.	2	
	The <u>DTR01 and DTR02</u> return will also need to be submitted to SARS via eFiling on the <u>same date</u> referred to above (s64K(1A)).	1	
4.2	<b>Reduction of dividends tax liability through election to reduce CTC</b>		
	In respect of the portion of the distribution to be made to Nebula NZL, Nebula SA could <u>elect to reduce contributed tax capital ('CTC') by that amount (R375,000)</u> . A reduction of CTC is specifically excluded from the definition of 'dividend' in section 1 of the Act and is also <u>not a 'dividend' as defined in section 64D of the Act for the purposes of dividends tax</u> . Therefore, that portion of the distribution will not be subject to dividends tax, resulting in the required dividends tax liability of <u>Rnil</u> .	2	
	However, it should be considered whether the <u>limit provided in the proviso</u> to the definition of 'contributed tax capital' in section 1 of the Act will allow such a reduction. Essentially, the limit for Nebula NZL is total CTC R800,000 x 75% (shareholding) = R600,000. Therefore, the <u>limit allows for the reduction of CTC in respect of the distribution to Nebula NZL in the amount of R375,000</u> . If such an election is made, no dividends tax liability will arise for Nebula NZL, as the return of capital is not a dividend for the purposes of dividends tax.	2	
<b>Note:</b>	Marks awarded for other relevant comments at the discretion of the examiner (e.g. para 76B considerations for Nebula NZL on the return of capital because shares are held and not disposed at the time of the reduction in Nebula SA's contributed tax capital).		

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		<b>Available: 14 Max: 10</b>	
	<b>Communication skills – layout, language, coherence</b>		
	<u>Format and layout:</u> Opinion includes clients address, date, subject line and the layout of the opinion is logical and easy to follows (headings and/or numbering used where appropriate). The overall impression is professional.	1	
	<u>Professional language and coherence of arguments:</u> The language used in the opinion 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.	2	
		<b>Available: 3 Max: 3</b>	
	<b>TOTAL FOR PAPER 4</b>	<b>50 MAX</b>	

**Annexure A – Suggested Solution and Mark Allocation**

Date loan granted	Description	Amount of loan in Currency	Currency	Exchange rate	Amount of loan in Rands (ZAR)	Comments	Marks	Tax treatment: inclusion of forex gain (+ve) / deduction of forex loss (-ve)
01-Jan-14	Loan granted by Nebula NZL	1,000,000	NZD	8.612	8,612,000		1	
01-Jul-14	Loan granted by Nebula NZL	500,000	NZD	9.343	4,671,500		1	
					13,283,500	'A' Per s24I(10A), forex gains or losses on loans between connected persons are only recognised on realisation, thus no recognition on translation dates (Nebula NLZ is a connected person to Nebula SA as it owns 75% of the shares, which is more than 20%).	1	
30-Jun-16	Loan repaid by Nebula SA	1,000,000	NZD	10.71	10,710,000		1	
30-Jun-16	Loan repaid by Nebula SA	500,000	NZD	10.71	5,355,000		1	
					16,065,000	'B'		
	2016: Forex gain / (loss) for tax purposes					('A' - 'B') [s24I(10A)]	2	(2,781,500)

For use of correct exchange rate to arrive at correct Rand amount

For use of correct exchange rate to arrive at correct Rand amount

For any valid supporting comments provided

For use of correct exchange rate to arrive at correct Rand amount (Note: per s24I(10A) - the ruling exchange rate on the last day of the year of assessment preceding the year in which it was realised must be used)

As above

For calculation of exchange loss

