Occupational Certificate: Tax Professional

External Integrated Summative Assessment (EISA)

Personal Taxation Question

EXEMPLAR 1

Instructions to Candidates

1. This external integrated summative assessment paper consists of one question.

   Time: 8 HOURS

2. Enter your examination number on each document and save all documents with your examination number.

3. Your name must not appear anywhere in the answer books or saved documents.

4. Answer the questions using effective presentation skills 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.

5. It is your responsibility to ensure that all assessment stationary are handed in to the invigilator before leaving the examination room and saved documents are forwarded as per assessment requirements.

6. Total marks for Paper 1: 100

7. Pass mark: 50 % pass is required per paper and competence achieved on all exit level outcomes per paper.

8. This is an open book assessment, thus all published bounded textbooks are allowed.

9. The case study simulates practice environment and therefore the answers are typed on a laptop and full access to internet allowed. Please note. No communication with 3rd parties are allowed. Please familiarise yourself with the EISA rules and regulations.

CASE STUDY

Mr. Fraser is a 40 year old South African resident who holds a diploma in design and has grown into an astute businessman over the years. He is happily married to his lovely 30 year-old wife, Alina, a Russian citizen who now resides in South Africa on a permanent basis. They are married out of community of property, without accrual, and have 10 children all below the age of 12. The children were all born in South Africa and have never been beyond the borders of South Africa. Mr. Fraser owns two businesses: *The Design@rt Shop* and Moon Stone Development.

The Design@rt Shop

Mr Fraser started a business, *The Design@rt Shop,* as a sole proprietor in 2006. *The Design@rt Shop* is a registered VAT vendor. Initially, the business operated from the garage at Mr Fraser’s home, but he now has a studio facility (where he employs and trains young inexperienced artists to create art pieces) and a gallery where he sells art supplies and artwork that he has created or purchased from independent artists, or that his young artists have created.

Despite the fact that Mr Fraser employs an accountant to prepare financial records for his business, Mr Fraser finds the administration of *The Design@rt Shop* a little confusing as he often finds it difficult to distinguish between his business and private interests in his own mind. To make this separation clearer in his mind, he is considering transferring the business into a separate entity at some point in the future and is currently seeking legal advice in this regard.

1. The Statement of Financial Position of *The Design@rt Shop*, as at 29 February 2016, is as follows:

	Note	Accounting book value	Original cost	Estimated market value
Art gallery	1.1	R2 500 000	R4 000 000	R5 500 000
Studio building	1.2	R2 000 000	R3 000 000	R3 500 000
Cash	1.3	R1 200 000	N/A	R1 200 000
Trade receivables	1.4	R500 000	N/A	R100 000
Trade creditors	1.5	(R300 000)	N/A	(R300 000)

1.1. The art gallery is located in a suburb of Johannesburg and attracts art-lovers and visitors. It was built by Mr Fraser during 2010 and is only used for purposes of selling the artwork on display and selling art supplies.

1.2. The studio building that was built by Mr Fraser in 2011 is used by artists employed by *The Design@rt Shop* to make their paintings, which are ultimately displayed and sold in the gallery.

1.3. This relates to a positive cash balance in the bank account used for *The Design@rt Shop*.

1.4. *The Design@rt Shop* does not normally sell artworks on credit. The trade receivables relate to artworks that were sold to an acquaintance of Mr Fraser for whom he made an exception and this debt was not considered doubtful as at 29 February 2016. However, this acquaintance is no longer contactable or traceable and Mr Fraser's accountant is of the view that as at 1 August 2016, this debt will have become irrecoverable.

1.5. The amount owing to suppliers of art supplies and independent artists who sell their paintings to Mr Fraser is normally in the range of R300 000 at any given time.

1.6. No equipment has been purchased since the equipment used in the gallery and studio building is either rented by Mr Fraser in terms of operating leases or is owned by the artists who prefer to use their own equipment.

2. Mr Fraser made a cash purchase of a brand new BMW X5 motor car on 1 March 2016 for an amount of R1 100 000. The car was purchased without a maintenance plan. The current retail market value of the vehicle is estimated to be approximately R900 000 and is likely to remain as such for the next 2 months.

Mr Fraser travels many hundreds of kilometres each year to see artists and assess their work before purchasing it for resale in the gallery. He also travels to potential customers on a regular basis. He selected the BMW X5 because of its spacious boot that enables him to transport a few paintings at a time – an especially useful feature when he takes paintings to prospective customers. He does however only own this one vehicle so he also uses it as his means of transport when he needs to travel for non-business purposes.

3. The Statement of Profit or Loss and Other Comprehensive Income of *The Design@rt Shop* for latest financial year ended 29 February 2016 is as follows:

	Note	R
Revenue from the sale of art work		12 000 000
Revenue from the sale of art supplies		1 500 000
Cost to purchase art from artists		(5 000 000)
Salary cost for in-house artists employed to create paintings	3.1	(500 000)
Cost of purchasing art supplies (for re-sale)		(1 000 000)
Depreciation	3.2	-
Travel costs	3.3	(200 000)
Other operating costs	3.4	(400 000)
Net profit for the business		6 400 000
Critical income	3.5	2 800 000
Flexible income	3.6	3 600 000

Notes

3.1. These up and coming artists are employed on a full-time basis by *The Design@rt Shop*. Their normal place of work is in the studio (refer note 1.2). The artists are all South Africans between the ages of 20 and 25 and they each earn approximately R5,900 per month. New employment contracts would be entered into between the employees and any new entity into which the business might be transferred in the future.

3.2. Mr Fraser prefers his business accounts not to reflect depreciation as he is of the opinion that this gives a skewed picture of the results. His accountant has however been claiming allowances under section 13*quin* of the Income Tax Act in respect of the art gallery (refer note 1.1) and section 13 allowances in respect of the studio building (refer note 1.2).

3.3. Travel costs consist of R120 000 for fuel and R80 000 for maintenance, insurance and licensing costs incurred in respect of his vehicle (refer note 2).

3.4. Other operating costs comprise of overhead costs such as water, electricity, insurance, the rental of equipment and other similar costs relating to the studio and gallery.

3.5. Mr Fraser has calculated that he would have required this amount of income, had he earned a salary as opposed to carrying on his own business, to survive from month to month and pay the bills as they fall due. Mr Fraser has therefore taken out an insurance policy to cover the loss of this income in case he is not able to work. The purpose of the policy is to ensure business continuity.

3.6. Any amount exceeding his "critical income" is considered a bonus if it is achieved by *The Design@rt Shop*. Such amounts are used by Mr Fraser for investments (to date, to repay his luxury residence and the Moon Stone Development – see below – which are his only assets besides *The Design@rt Shop* assets listed above).

Moon Stone Development

Mr Fraser tried his hand at property development during 2013. Using the services of a number of VAT registered construction contractors, he constructed 10 residential houses on a one-hectare piece of land. On the advice of his accountant, he registered the property development enterprise, Moon Stone Development (Moon Stone), as a separate vendor for VAT purposes prior to the commencement of the development activities.

Moon Stone claimed input tax in respect of the following costs:

(a) Acquisition of the one-hectare piece of land for an amount of R700 000. The land was acquired from a subsistence farmer who was a Mozambican resident who owned the land and was not registered as a VAT vendor. Mr Fraser never got his name as the seller was only able to speak Portuguese.

(b) All construction costs incurred, which amounted to R4 000 000 (excluding VAT).

After completion, the Moon Stone Development was actively marketed. To Mr Fraser's surprise the first house (unit) was sold quickly for an amount of R600 000 (excluding VAT), but no further units have been sold since then. Mr Fraser still actively markets the units, but has also started to rent out the units while waiting for a purchaser. The main cost Moon Stone still incurs is the monthly total payment of R17 100 to a VAT-registered security company that patrols the secured area to ensure the safety of the tenants and also ensure that unoccupied units are not occupied by squatters. Moon Stone' income for all VAT periods since 1 June 2014, when the only unit sold to date was sold, consisted of rental income it received from the tenants. Only four of the available units are occupied in terms of rental agreements concluded in July 2014, subject to a one-month notice period should Moon Stone be able to sell the unit. The other units are unoccupied. The units are still actively marketed but without any success.

SARS issued an additional VAT assessment on 1 July 2016 in relation to the activities of Moon Stone Development. The details on the assessment are summarised below:

	Amount	Reason
In respect of VAT period 04/2013:		
Input tax in respect of purchase of land disallowed	R85 965	Taxpayer is not entitled to claim input tax as there was no output VAT on the supply
In respect of VAT period 04/2015		
Output tax change in use adjustment	R756 000	Assets not used to make taxable supplies as all income of Moon Stone derived from rentals. Adjustment based on estimated market value of R600 000 per unit (excluding VAT).
In respect of VAT periods 08/2014 to 06/2016		
Input tax disallowed as expenses related to making exempt supplies.	R46 200	Expenses do not relate to the making of taxable supplies.
Total additional VAT assessed	R888,165	
Add:		
• Penalty for late payment	R88 817	
• Interest at prescribed rate from relevant periods	R101 983	
• Understatement penalty @ 200%	R2 157 929	
Total amount payable	R3 236 894	

According to Mr Fraser, this venture has already been a failure from a financial perspective. To make matters worse, he has been informed by his bank that it has received instruction from SARS to pay any amounts that come into his personal bank account and *The Design@rt Shop* bank account over to SARS until the amount of R3 236 894 has been settled. This instruction states that it will take effect if the amounts in question have not yet been paid over to SARS by 1 September 2016.

Legal Advice Obtained

Mr Fraser has obtained advice from a lawyer regarding *The Design@rt Shop* and Moon Stone.

The lawyer has indicated the following with regard to Mr Fraser's wish to transfer *The Design@rt Shop* into a separate entity:

- Mr Fraser should either transfer *The Design@rt Shop* business to a trading trust, where he acts as one of the trustees and could be a beneficiary together other beneficiaries, or he should incorporate a private company, where he is the sole holder of shares (as well as being the managing director and receiving a salary). Other forms of entities were considered inappropriate for legal reasons.
- Regarding the method of transfer, the lawyer has advised that he should not donate the business assets to the new entity, but should rather sell the business assets to the new entity on an interest-free loan account. In the case of the private company option, the lawyer has advised that Mr Fraser has the additional option of selling the business in return for ordinary shares.
- The lawyer has indicated that he cannot advise on the transactions from a tax perspective, but from a legal perspective he is indifferent between the trust and the company as a preferred entity for the business to be continued in.

The lawyer has given him some assurance that if *The Design@rt Shop* business can be transferred to another entity before 1 September 2016, his main source of income should be safe from the instruction from SARS to the banks to pay any amounts received over to SARS in order to settle the Moon Stone R3 236 894 VAT liability.

Mr Fraser is happy with the legal advice and would not like to deviate from it. The tax implications of the transfer to the entity and the tax implications of operating a business in that form of entity, will be the decisive factor in his choice between the two alternatives. He has therefore approached you to assist him in understanding the tax implications as well as recommending which alternative to follow. He would also like your advice regarding the Moon Stone VAT issues.

REQUIRED

QUESTION

Required		Marks
A	Mr. Fraser has a number of specific questions for which he requires tax advice. You are required to prepare a tax opinion in which you advise Mr. Fraser on the following:	
	i. the income tax consequences for Mr. Fraser if he continues to use the BMW X5 (see note 2) for all his driving needs after it has been transferred to the new entity (trading trust or private company), assuming such new entity would pay for all costs associated with the vehicle. Contrast this with the income tax consequences for Mr. Fraser if the vehicle is not transferred to the new entity and he continues to use it for all his driving needs (and continues to bear all the costs thereof), but receives a travel allowance from the new entity;	10
	ii. the income tax implications for both himself and the new entity (trading trust or private company), if the insurance policy (see note 3.5) was retained in his own name or alternatively, if the new entity became the policyholder for this policy and paid the premiums in this regard;	4
	iii. the income tax implications of transferring *The Design@rt Shop* business to the private company, using each of the two methods suggested (i.e. selling the business on an interest-free loan account or selling the business in exchange for ordinary shares);	28
	iv. advice regarding any tax incentive regimes that the new entity (trading trust or private company) could benefit from;	7
		7

	v. the income tax and estate duty implications specific to carrying on *The Design@rt Shop* business in a trading trust; and	5
	vi. whether it would be more beneficial, from a tax perspective, to run *The Design@rt Shop* business as a trading trust or as a private company	7
	Marks awarded for professional opinion writing skills (including structure of opinion, appropriate professional language and style, logical approach to queries and scope of advice).	
	For purposes of the above tax opinion, you: • *may assume that the transfer would take place on 1 August 2016;* • *need to only perform detailed calculations where the information in the scenario is sufficient to do so and such a calculation is necessary in your view; and* • *may assume that Mr. Fraser has retained sufficient documentation to substantiate expenditure incurred for purposes of the Tax Administration Act.*	

Required		Marks
B	Prepare a tax opinion in which you provide Mr. Fraser with views on: i. whether he has grounds to argue (dispute) the Moon Stone VAT assessment issued to him by SARS and what the grounds are; ii. a high level recommended approach to resolve the dispute (if any) relating to the assessment; and iii. other actions you would recommend him to take in an attempt to ease his cash flow pressures caused by the additional assessment. *You may assume that this correspondence will be send to him today.*	32

Total marks for the paper	**100**

ANNEXURE A

TAX RATES AND ALLOWANCES

Where relevant, the following tax rates and allowances may be used in answering the questions.

Rates of normal tax payable by persons (other than companies) for the year of assessment ended 29 February 2016

Where taxable income:

does not exceed R181,900	18% of each R1 of the taxable income
exceeds R181,900 but does not exceed R284,100	R32,742 plus 26% of the amount over R181,900
exceeds R284,100 but does not exceed R393,200	R59,314 plus 31% of the amount over R284,100
exceeds R393,200 but does not exceed R550,100	R93,135 plus 36% of the amount over R393,200
exceeds R550,100 but does not exceed R701,300	R149,619 plus 39% of the amount over R550,100
exceeds R701,300	R208,587 plus 41% of the amount over R701,300

Rates of normal tax payable by persons (other than companies) for the year of assessment ended 28 February 2017

Where taxable income:

does not exceed R188,000	18% of each R1 of the taxable income
exceeds R188,000 but does not exceed R293,600	R33,840 plus 26% of the amount over R188,000
exceeds R293,600 but does not exceed R406,400	R61,296 plus 31% of the amount over R293,600
exceeds R406,400 but does not exceed R550,100	R96,264 plus 36% of the amount over R406,400
exceeds R550,100 but does not exceed R701,300	R147,996 plus 39% of the amount over R550,100
exceeds R701,300	R206,964 plus 41% of the amount over R701,300

Year ended 29 February 2016

Rebates	
Primary rebate	R 13,257
Secondary rebate (over 65)	R 7,407
Tertiary rebate (over 75)	R 2,466

Year ended 28 February 2017

Rebates	
Primary rebate	R 13,500
Secondary rebate (over 65)	R 7,407
Tertiary rebate (over 75)	R 2,466

Trusts (other than a special trust) tax rate:	2016: 41%; 2017: 41%
Dividends tax rate:	2016: 15%; 2017: 15%
Companies tax rate:	2016: 28%; 2017: 28%
Donations tax rate:	2016: 20%; 2017: 20%
Estate duty:	2016: 20%; 2017: 20%

Capital gains tax for the year of assessment ended 29 February 2016

Annual exclusion (while alive)	R30,000
Annual exclusion (in year of death)	R300,000
Primary residence exclusion	R2,000,000
(where proceeds are R2 million or less, the full gain is excluded for the portion of the property used for domestic purposes as a primary residence)	
Inclusion rate (natural persons)	33.3%
Inclusion rate (non-natural persons)	66.6%

Capital gains tax for the year of assessment ended 28 February 2017

Annual exclusion (while alive)	R40,000
Annual exclusion (in year of death)	R300,000
Primary residence exclusion	R2,000,000
(where proceeds are R2 million or less, the full gain is excluded for the portion of the property used for domestic purposes as a primary residence)	
Inclusion rate (natural persons)	40%
Inclusion rate (non-natural persons)	80%

Tax rates for small business corporations for the year of assessment ended 31 March 2016

Where taxable income:

- does not exceed R73,650	Nil
- exceeds R73,650 but does not exceed R365,000	7% of the amount over R73,650
- exceeds R365,000 but does not exceed R550,000	R20,395 plus 21% of the amount over R365,000
- exceeds R550,000	R59,245 plus 28% of the amount over R550,000

Tax rates for small business corporations for the year of assessment ended 31 March 2017

Where taxable income:

- does not exceed R75,000	Nil
- exceeds R75,000 but does not exceed R365,000	7% of the amount over R75,000
- exceeds R365,000 but does not exceed R550,000	R20,300 plus 21% of the amount over R365,000
- exceeds R550,000	R59,150 plus 28% of the amount over R550,000

Car allowance

Maximum vehicle cost for actual expenses: 2016: R560,000; 2017 R560,000

Travel allowance table for years of assessment commencing on or after 1 March 2015

Value of the vehicle (incl VAT but excl finance charges or interest)			Fixed cost	Fuel cost	Maintenance cost
	R		**R p.a.**	**c/km**	**c/km**
0	-	80,000	26,105	78.7	29.3
80,001	-	160,000	46,505	87.9	36.7
160,001	-	240,000	66,976	95.5	40.4
240,001	-	320,000	84,945	102.7	44.1
320,001	-	400,000	102,974	109.9	51.8
400,001	-	480,000	121,886	126.1	60.8
480,001	-	560,000	140,797	130.4	75.6
Exceeds		560,000	140,797	130.4	75.6

Note: Fixed allowance, where distance travelled does not exceed 8,000 kms: R3.18 per kilometer.

Travel allowance table for years of assessment commencing on or after 1 March 2016

Value of the vehicle (incl VAT but excl finance charges or interest)			Fixed cost	Fuel cost	Maintenance cost
	R		**R p.a.**	**c/km**	**c/km**
0	-	80,000	26,675	82.4	30.8
80,001	-	160,000	47,644	92.0	38.6
160,001	-	240,000	68,684	100.0	42.5
240,001	-	320,000	87,223	107.5	46.4
320,001	-	400,000	105,822	115.0	54.5
400,001	-	480,000	125,303	132.0	64.0
480,001	-	560,000	144,784	136.5	79.5
Exceeds		560,000	144,784	136.5	79.5

Note: Fixed allowance, where distance travelled does not exceed 8,000 kms: R3.29 per kilometer.

***