South African Institute of Tax Professionals

Occupational Certificate: Tax Professional

External Integrated Summative Assessment (EISA)

Corporate Taxation Question

EXEMPLAR 2 SOLUTIONS

PART 1 (70 Marks)

SUGGESTED SOLUTION: PART 1 – HAPPY DAYS *Note: All section references refer to the Income Tax Act unless stated otherwise.*		
a	With reference to Note 1, briefly explain the Securities Transfer Tax ('STT') implications of this transaction. Your answer should include a calculation of the STT liability, who is liable to pay the STT, and the date by which it must be paid.	MARKS
	R1,800,000 x 0.25% = R4,500 (section 2(1) of the STT Act)	1
	Goodies is liable for the STT (section 6(2) of the STT Act). However, Goodies may recover the STT from Happy Days (section 7(2) of the STT Act).	2
	It must be paid to SARS two months from the end of the month during which the transfer took place ie by 31 March 2015 (section 3(1)(c) of the STT Admin Act).	1
	Available	4
	Maximum	4

b	With reference to Note 2, discuss whether the overpayments on the debtors' accounts should be included in Happy Days' gross income, with reference to relevant case law.	MARKS
	The issue is whether the overpayments were 'received' for purposes of gross income definition. Note: the issue is not whether the amount was 'accrued' as the gross income inclusion is based on the earlier of receipt and accrual and the amount has already been received in the 2015 year of assessment.	2
	It should be considered whether the overpayment was received by Happy Days for its own benefit (Geldenhuys). As Happy Days had the use of monies and was not legally obligated to repay (as is the case with a borrowed amount - Genn), overpayments were received for Happy Days' benefit.	2
	Although circumstances could later arise that would oblige Happy Days to refund the overpayment (e.g when requested by customer), Happy Days had the full benefit of, and legal entitlement to, the overpayments and could use them in its business as it pleased (Pyott). Mere existence of a claim for refund of money would not result in no receipt (COT v G). Therefore the overpayment of R35,000 should be included in gross income	2
	Total amount, cash or otherwise, not of a capital nature - not in issue.	1
	s102 of TAA - burden of proof	1
	Mark for presentation, structure, coherence of answer	1
	Available	9
	Maximum	8

c	With reference to the information contained in Note 3 through to Note 10, briefly explain what the normal tax treatment of each of these items would be in Happy Days' computation of taxable income (which begins with the net accounting loss before tax). *Marks awarded range between 1 and 3 marks for each item. No calculations are required, but references to the most relevant sections of the Act should be given to support your explanations.*	MARKS

Note 3: The movement in the provision for bad debts in the amount of R60,00 is not deductible for normal tax purposes and should be reversed in the tax computation because these provisions are conditional liabilities and therefore the expense is not actually incurred for purposes of section 11(a). However, as the provision relates to specific debtors, Happy Days may claim a s11(j) doubtful debt allowance based on 25% of the doubtful debts provision of R120,000. The prior year s11(j) allowance of R15,000 should be reversed in the tax computation.	3
Note 4: The prepayments are for expenses that would be deductible in terms of s11(a) and are in respect of goods or services to be rendered within 6 months and are in any event less than R100,000. Therefore the R92,500 prepayments are not limited by s23H and should be allowed as a deduction.	2
Note 5: Section 7B requires that 'variable remuneration' (which includes leave pay and bonuses) is only deemed to constitute expenditure incurred by Happy Days in the year of assessment in which the amount is paid. As it is company policy to pay out the bonuses and leave pay two month after year end, the movement of R90,000 is not deductible and should be reversed in the 2015 tax computation.	2
Note 6: No adjustment required as the payables relate to deductible expenditure in terms of s11(a).	1
Note 7: Interpretation Note 47 provides an acceptable write-off period for self-developed computer software of 1 year. This appears to differ to the rate of amortisation. Therefore, the 2015 amortisation expense of R28,440 should be reversed in the tax computation and a s11(e) allowance in the amount of R10,400 should be claimed. [Note: the normal tax consequences of the disposal of the computer software are set out below in the solution to question (e).]	3
Note 8: The consulting fees relate to the acquisition of shares which will produce exempt dividends which would not constitute income as defined in s1. Therefore, the deduction of R45,000 is prohibited in terms of s23(f).	2
Note 9: No adjustment is required as s11(e) wear and tear and depreciation are calculated on the same basis. Alternatively, the depreciation of R30,500 could be reversed and the s11(e) allowance of R30,500 could be claimed.	1

	Note 10: No deduction may be claimed since the s18A receipt is not available (s18A(2)). However it should be considered whether the donation will qualify for a deduction in terms of s11(a). This would involve an examination of the purpose of the donation (e.g marketing?) and the closeness of the connection between the donation and the income-earning operations of the business.	2
	Available	16
	Maximum	15

d	With reference to Note 11, discuss whether the interest expense of R152,000 would be treated as deductible in Happy Days' computation of taxable income and whether there are any limitations applicable. *No calculations are required, but references to the most relevant sections of the Act should be given to support your explanations.*	MARKS
	Section 24J(2) only allows a deduction from the income of a person derived from carrying on any trade, if that amount is incurred in the production of the income. Whether interest constitutes expenditure incurred in the production of income involves an enquiry into the purpose of the expenditure and what it actually effects. The purpose of the loan from SA Bank was to acquire shares in Goodies which will give rise to exempt dividends which would not constitute 'income' as defined in s1(1). Therefore the deduction of the interest is prohibited in terms of s23(f).	3
	However, s24O requires affords an interest deduction where debt is used to acquire a controlling equity share interest in an 'operating company' (an 'acquisition transaction'). Since it appears that Goodies is an 'operating company' as defined (as it carries on business continuously and provides goods for consideration in the course of the business), and since Happy Days acquires 100% of the equity shares in Goodies, the requirements for the application of s24O appear to be satisfied, which would mean that the interest of R152,000 would be deductible.	2

	However, s23N imposes a limitation on the interest that may be claimed as a deduction. It appears that s23N would apply since the interest incurred by Happy Days was in respect of a debt used in terms of an 'acquisition transaction'. The effect of s23N is that the interest deduction would be limited in the current year (and in the 5 subsequent years) to an amount determined in accordance with a formula (see s23N(3) and s23N(4)). Any excess interest would be permanently lost. (Or any other valid point on s23N.)	3
	Mark for presentation, structure, coherence of answer.	1
	Available	9
	Maximum	8

e	With reference to Note 12, briefly explain the various tax consequences for Happy Days in respect of the distribution of the ownership and copyright in the computer software. *Please support your explanations with calculations of the tax implications as well as references to the most relevant sections of the Act.*		MARKS
	The 200,000 accounting profit should be reversed in the tax computation.		1
	Recoupment: As the computer software was self-developed, all the capitalised costs would have been claimed as a s11(e) wear and tear allowances with a 1 year write-off period. Therefore, all the capitalised costs would have been deducted for normal tax purposes. Therefore the transfer of the asset to GiftsUK would trigger s8(4)*(k)*(ii) recoupment in the amount of R250,000.		2
	CGT: The transfer of the computer software is a disposal for CGT purposes. Therefore the s26A inclusion in the tax computation is calculated as follows:		
	Proceeds (para 75 of Eighth Schedule - proceeds equal to market value)	300,000	2
	Less recoupments (s8(4)(k)(ii))	(250,000)	0.5

		50,000	
Base cost (para 20)	250,000		1
Less allowances (s11(e))	(250,000)		0.5
	-		
Net capital gain	50,000		1
Taxable capital gain (after inclusion rate of 66.6% applied)	33,300		1

Dividends Tax: The distribution of the computer software is a 'dividend' as defined in s1(1).	1
As the dividend consists of a distribution of an asset *in specie*, Happy Days is liable for the Dividends Tax (s64EA(b)).	1
The dividend is deemed to be paid on the earlier of the date on which it was paid and the date it becomes due and payable (s64E(2)(b)). According to the scenario, these occur on the same date - 28 February 2015.	1
The amount of the dividend is the market value of the asset on the day it is deemed to be paid (s64E(3)(b)). According to the scenario, the market value is R300,000.	1
Therefore the Dividends Tax Liability is R300,000 x 15% = R45,000 (s64E(1)	1
However, the DTA between SA and the UK provides that withholding tax on dividends is 5% if the beneficial owner of the dividend is a company which controls at least 10% of the capital. In this scenario, GiftsUK is the beneficial owner of the dividend and is the sole shareholder, thus the 5% rate should apply.	1
However, Happy Days may only withhold the Dividends Tax at the reduced rate if a declaration and written undertaking was obtained as per s64G(3).	1

	Happy Days was required to <u>submit a return</u> (DTR01 and DTR02) to SARS by the last day of the month following the month in which the dividend is paid (see section 64K(1A) and the was also required to <u>withhold the Dividends Tax and pay</u> it over to SARS by the same date (see section 64EA(b) read with section 64K(1)(b)). In the present scenario, the due date is <u>31 March 2015</u>.	2
	Mark for presentation, structure, coherance of answer.	1
	Available	19
	Maximum	15

f	With reference to Note 14, briefly explain whether the unrealised foreign exchange loss is deductible for normal tax purposes.	MARKS
	No calculations are required, but references to the most relevant sections of the Act should be given to support your explanations.	
	In terms of <u>s24I(10A)</u>, the R88,000 should be <u>deferred (ie is not deductible</u> in 2015) because:	1
	- The parties to the exchange item (Happy Days and GiftsUK) are <u>connected persons</u>;	1
	- <u>No portion</u> of the exchange item is a <u>current asset or current liability</u> for purposes of IFRS (per the TB);	1
	- The exchange item is not directly / indirectly funded by a debt owed to a person that is unconnected to the parties to the exchange item (as it was <u>funded by GiftsUK's own cash reserves</u>); and	1
	- <u>No FEC or FCOC</u> has been taken into account to hedge the exchange item (given in the question).	1
	Available	5
	Maximum	4

g	Based on the information provided, prepare a computation of taxable income for Happy Days' 2015 year of assessment, **starting with the net loss before tax**.	MARKS
	Please show your workings where appropriate. Your computation must be set out in a table with 3 columns labelled as follows: Description of tax adjustment, Workings, Amount.	
	See page for solution.	16
	Available	16
	Maximum	14

h	Based on the information provided, please identify and explain 1 potential tax risk that the directors of Happy Days should be aware for the 2016 year of assessment.	MARKS
	Marks if students identified any 1 of the below (or any other valid tax risk)	
	VAT registration - Happy Days is nearing the R1 million value of taxable supplies in a 12 month period. Happy Days should monitor the total taxable supplies closely as once it exceeds R1 million, VAT registration is compulsory (s23(1)(a).	2
	s23I - The computer software may be considered to be 'tainted intellectual property' for purposes of s23I and therefore the regular payment that will be made by Happy Days to GiftsUK for the right of use thereof, might not be deductible (s23I(2)(a))	
	Withholding tax on royalties - The monthly fee for the right of use of the computer software appears to meet the definition of a royalty in s49A and therefore may be subject to withholding tax on royalties at a rate of 15% (s49B(1)). However, this rate may be reduced in terms of the DTA between South Africa and the UK.	
	Available	2
	Maximum	2

PART 1 - TOTAL MARKS AVAILABLE	**70**

g	Description of Adjustment	Workings	Amount	MARKS	
	Net loss before before tax	(185,370) + 40,550	(144,820)	1	
	Overpayments (not already included in gross income)		35,000	1	
	Reversal of provision for doubtful debts		120,000	0.5	*
	Prior year provision for doubtful debts		(60,000)	0.5	
	Doubtful debts allowance s11(j) - current year	120,000 x 25%	(30,000)	1	
	Doubtful debts allowance s11(j) - prior year reversal		15,000	1	
	Prepayments not limited by s23H (under R100,000)		(92,500)	1	
	Prior year prepayments reversal		-	0	
	Reversal of provision for leave pay and bonuses		500,000	0.5	*
	Prior year provision for leave pay and bonuses	330,000 + 80,000	(410,000)	0.5	
	Amortisation of computer software		28,440	1	
	Wear and tear s11(e) - self developed software (IN 47)		(10,400)	1	
	Consulting fees prohibited s23(f)		45,000	1	
	Donations - no s18A receipt		15,000	1	
	Accounting profit on distribution of assets		(200,000)	1	
	Recoupment on distribution of computer software s8(4)(k)		250,000	1	
	Unrealised exchange differences deferred s24I(10A)			1	

			88,000	
	Taxable capital gain	*Refer to question (e) for calculation*	33,300	1
	Taxable income		**182,020**	1

* Adjustment for the movement in the provision only is also acceptable.

Available	16
Maximum	15

PART 2 (30 Marks)

SUGGESTED SOLUTION: PART 2 – ABC Group *Note: All section references refer to the Income Tax Act unless stated otherwise.*		
	The financial manager of ABC has approached you with a number of queries regarding the tax implications of the proposed transaction steps for the group. You are required to draft a short, concise report to the manager, addressing his specific queries as follows:	
	Presentation, professional language and structure	3

i.	Briefly explain the income tax implications of Step 4 for ABC.	MARKS
	The issue of shares by ABC results in an increase in the company's contributed tax capital. In ABC's instance its contributed tax capital will increase by R1 million).	1
	The issue of shares is not regarded as a disposal of assets in terms of paragraph 11(2)(b) of the Eighth Schedule.	1

	No other income tax implications. (Or any other valid comment)	1
	Available	3
	Maximum	3

ii	Briefly explain the income tax and dividends tax implications of Step 3 for ABC.	MARKS
	Although the accrual or receipt of dividends by ABC from DEF will be included in ABC's gross income in terms of paragraph (k) of the gross income definition in section 1 of the IT Act, it will be exempt from normal tax in terms of section 10(1)(k)(i) of the IT Act. This is due to the fact that DEF is a resident company and none of the exclusions apply.	2
	As ABC, the beneficial owner of the dividend, is a South African resident company, the dividend paid to ABC will be exempt from dividends tax in terms of section 64F(1)(a).	1
	However, ABC is still required to submit a dividends tax return (DTR01 and DTR02) to SARS in terms of s64K(1A)(b) by the last day of the month following the month in which the dividend is received. (Or any other valid comment).	1
	Available	4
	Maximum	4

iii	Briefly explain the income tax implications Step 2 for DEF.	MARKS
	The receipt of money on loan is not gross income, because the receipt is matched by an obligation to repay the amount in the future.	1

	A loan will only give rise to gross income in the hands of the borrower if it is made as a *quid pro quo* (in return for) some good or service and is interest-free or at a low rate of interest. In such case, gross income is the benefit arising from the fact that the borrower does not have to pay interest (as opposed to the amount of the loan) (Brummeria)	1
	Interpretation Note 58 confirms that the principles enunciated in the Brummeria case would only apply in the instance where an interest-free loan is granted in exchange (quid pro quo) for goods supplied, services rendered on any other benefit granted.	1
	Therefore, the interest-free loan in this scenario would not result in any gross income implications for DEF as DEF does not provide any goods, services or any other benefit to XYZ in exchange for the interest-free loan.	1
	As the interest-free loan is be owed to XYZ by a company (i.e. DEF) it is submitted that the interest-free loan will not trigger the deemed dividend provisions of section 64E(4). (Or any other valid comment)	1
	Available	5
	Maximum	4

iv.	With reference to Step 2, briefly explain the income tax implications for DEF and XYZ if XYZ were to waive its right to repayment of this loan.	MARKS
	From DEF's perspective the waiver of the loan amounts to a debt reduction and therefore section 19 and para 12A of the Eighth Schedule should be considered.	1
	Section 19 will not apply as DEF uses the interest-free loan for the payment of dividends to ABC. Therefore, the purpose of the debt is not to fund tax deductible expenditure.	2

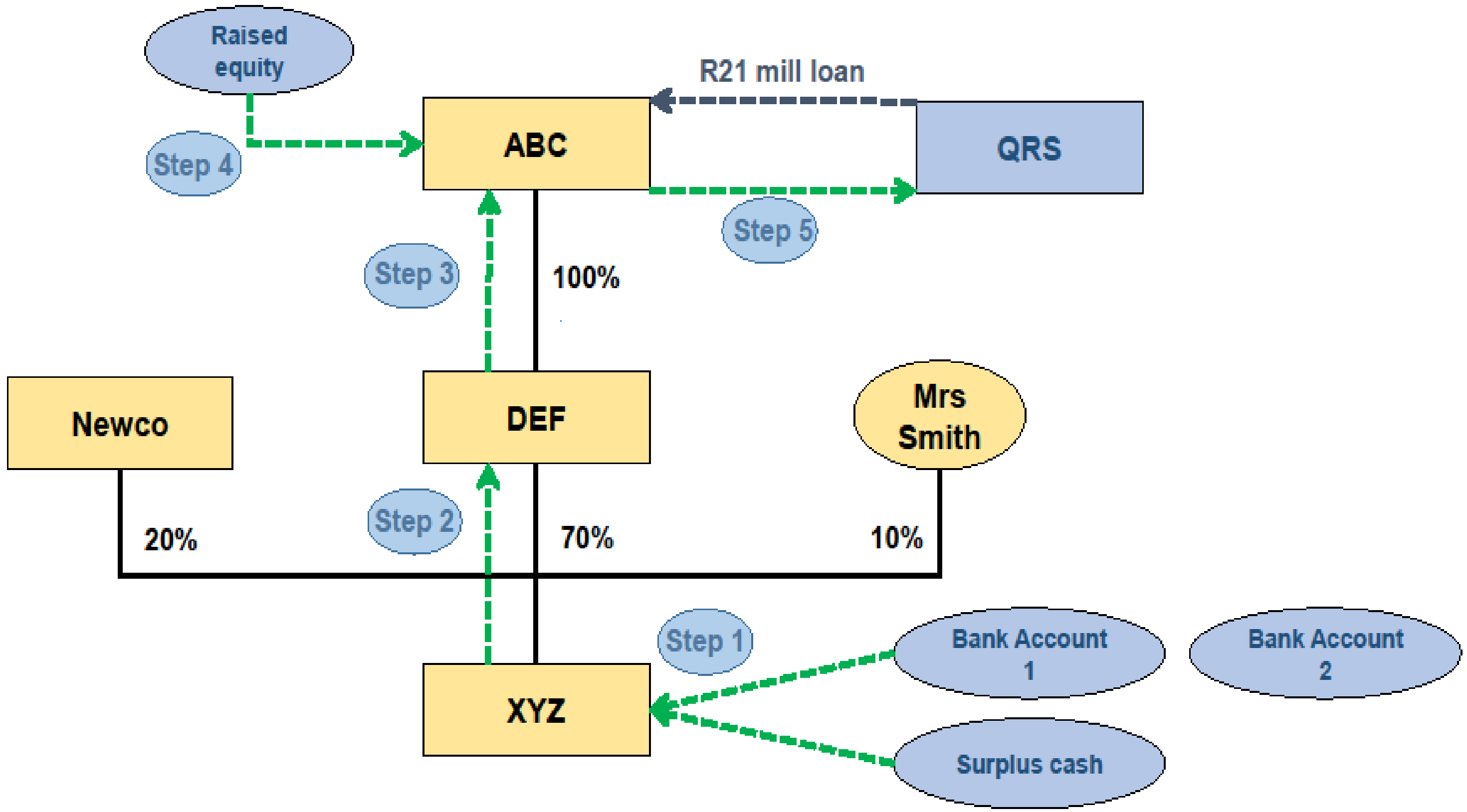
	Para 12A would apply but for the fact that para 12A(6)(d) determines that paragraph 12A will not apply to any debt owed by a person to another person where that person and that other person are companies that form part of the same group of companies as defined in section 41, unless, as part of any transaction, operation or scheme entered into to avoid any tax imposed by the IT Act – (i) that debt (or any debt issued in substitution for that debt), was acquired directly or indirectly from a person who does not form part of that group of companies; or (ii) that company or that other company became part of that group of companies after that debt (or any debt issued in substitution for that debt) arose; <u>Since the companies formed part of the same group of companies and did so before the debt arose</u>, <u>none of the provisos contained in subparagraphs (i) and (ii) applies to DEF and XYZ and therefore para 12A would not apply.</u>	3
	Consequently, there are <u>no income tax implications for DEF</u> in respect of this step	1
	From XYZ's perspective, the provisions of <u>para 56</u> will apply to the waiver of debt. The paragraph determines that when a creditor disposes of a debt owed by a debtor who is a connected person, the creditor (ie XYZ) <u>must disregard any capital loss</u> on the disposal.	2
	Available	9
	Maximum	8

v.	With reference to Step 2, briefly discuss whether XYZ should consider paying DEF the R20 million cash as a dividend rather than as an interest-free loan	MARKS
	If one <u>assumes that the shares held by NewCo Ltd and Mrs Smith are of the same class as that of DEF's</u>, then it would follow that a dividend will also have to be paid to them as their shares entitle them to the same rights and benefits as those of DEF's. This would result in <u>additional funds having to be utilised by XYZ to pay said dividends</u>. This effectively results in a dividend leakage.	2

	If the full amount of R20 million is paid as a dividend to DEF, then it effectively means that the following amounts should be paid as dividends to Newco and Mrs Smith, respectively: -> A gross dividend of approximately R5.7 million (R20 million / 70% x 20%) to Newco. The dividend will be exempt from dividends tax in terms of section 64F(1)(a) as Newco Ltd is a resident company; -> A gross dividend of approximately R2.9 million (R20 million / 70% x 10%) to Mrs Smith. The dividend will be subject to dividends tax of 15% (approximately R0.4 million) as Mrs Smith is a natural person for which no exemption exists. From the above it follows that if dividends of R20 million are paid to DEF an additional amount of about R8.6 million will have to be paid by XYZ to its other shareholders. *(Or any other valid argument)*	2
	From a tax perspective and a cash flow perspective, the interest-free loan is the better option.	1
	Available	5
	Maximum	4
b	Please identify one potential tax risk for XYZ with regard to the proposal for a separate 'gross turnover bank account' and 'operating expenses bank account' and briefly explain your reasons for highlighting this as a risk.	MARKS
	Risk: Interest on the working capital facility may not be deductible. With regard to the deductibility of interest, the purpose of the loan (working capital facility) should be examined as well as the closeness of the connection between this and the income-earning operations. It could be argued that while it appears that the purpose of the loan (working capital facility) is to fund deductible operating expenditure, the true purpose of the loan is the indirect funding of an interest-free loan to DEF (since the if the ring-fenced turnover was not being used for this purposes, then XYZ would have had to obtain a loan to finance the interest-free loan to DEF). As the DEF loan is interest-free, the interest paid on a loan used to finance an interest-free loan, would not be deductible as it would not be in the production of income.	4

OR: Risk: SARS may apply GAAR. SARS may apply the GAAR (s80A to 80L) where the sole or main purpose (of any part of the structure, scheme or arrangement) is to obtain a tax benefit; and -> it was entered into or carried out in a manner which would not normally be employed for bona fide business purposes; or -> it lacks commercial substance ; or -> it has created rights or obligations that would not normally be created between persons dealing at arm's length; or -> it would result in the "misuse or abuse of the provisions" of the Act. It is submitted that there is a potential 'tax benefit' in structuring the bank accounts as XYZ proposes since, by utilising the turnover for the funding of the interest-free loan, XYZ requires a working capital facility to fund deductible operating expenditure and it may be considered that the interest expense in respect of the working capital facility is tax deductible as the purpose of the loan was to fund deductible expenditure (if one does not apply the argument set out under the interest deductibility risk above). However, if the turnover had not been ring-fenced, XYZ would have had to obtain a loan to finance the loan to DEF. As the DEF loan is interest-free, the interest paid on a loan used to finance this loan, would not be deductible as it would not be in the production of income. In order for this arrangement to not be considered 'impermissible tax avoidance', XYZ would need to be able to prove that the other components listed above do not apply (normality, commercial substance, misuse and abuse etc.).	
OR: Any other valid tax risk identified.	
Available	4
Maximum	4

PART 2 - TOTAL MARKS AVAILABLE	**30**


Raised
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