South African Institute of Tax Professionals

Occupational Certificate: Tax Professional

External Integrated Summative Assessment (EISA)

Corporate Taxation Question

EXEMPLAR 2

South African Institute of Tax Professionals

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

Part One **Weight 70**

*Amounts indicated per question is a percentage weighted scale of the total paper weight. This is an indication of how much time you spend on Part One.

Happy Days Trading (Pty) Ltd ('Happy Days') operates an online 'shop' selling a wide variety of gifts and flower arrangements. Products ordered online are delivered to customers throughout South Africa. The business operations (administration, management, finance, warehousing and distribution) are conducted from rented premises in Cape Town. Happy Days meets the definition of a 'resident' in section 1(1) of the Income Tax Act 58 of 1962 ('the Act') and is not a VAT vendor. Happy Days is wholly owned by GiftsUK Limited ('GiftsUK'), a private company incorporated in the United Kingdom.

The 2015 audit is nearing completion and the audited trail balance is set out below. Additional information has been provided (set out in Note 1 – 14) which may be relevant for tax purposes.

Happy Days - Trial balance for the financial year ending 28 February 2015		
Computer software - Cost	-	
Computer software - Accumulated amortisation	-	
Fixtures and fittings - Cost	1,610,530	
Fixtures and fittings - Accumulated depreciation	(201,500)	
Investment in group companies - Goodies	1,800,000	Note 1
Trade receivables	540,000	Note 2
Trade receivables - Provision for doubtful debts	(120,000)	Note 3
Prepayments	92,500	Note 4

Bank	274,920	
Share capital	(100)	
Retained income	(380,000)	
Non-current liabilities - non interest-bearing loan - GiftsUK	(900,000)	
Non-current liabilities - interest-bearing - SA Bank	(1,530,000)	
Current liabilities - interest-bearing - SA Bank	(270,000)	
Provisions	(500,000)	Note 5
Other payables	(301,720)	Note 6
Sales	(980,360)	
Cost of sales	120,300	
Amortisation expense - computer software	28,440	Note 7
Annual bonus and leave pay	90,000	Note 5 *(repeat)*
Basic salaries	300,340	
Consulting expense	45,000	Note 8
Depreciation expense - furniture and fittings	30,500	Note 9
Donations	15,000	Note 10
Doubtful debts	60,000	Note 3 *(repeat)*
Interest expense - SA Bank loan	152,000	Note 11
(Profit) / loss on distribution of assets	(200,000)	Note 12
Unrealised foreign exchange (gains) / losses	88,000	Note 13
Other operating expenses	95,600	Note 14
Income tax expense	40,550	
	-	

Net loss after tax is R185,370

Note 1: On 15 January 2015, Happy Days acquired 100% of the equity shares (as defined in section 1(1) of the Act) in Goodies (Pty) Ltd ('Goodies'), a South African resident company specialising in the procurement, assembly and sale of unique gift packages for special occasions. The shares in Goodies were acquired from Mr Jones, an unconnected third party.

Note 2: There are a number of debtors with credit balances. This is as a result of customers that place regular orders on account, and make fixed scheduled payments each month in order to settle their accounts. For some of these customers, the payments made were in excess of the balance due on their account, resulting in credit balances. According to the terms and conditions of the sale agreement entered into by each customer (by clicking 'accept' on the online order form), any overpayments are legally the property of Happy Days unless and until the customer requests a refund thereof at which point the funds are immediately repaid. The total overpayments amount to R35,000 as at 28 February 2015.

Note 3: The provision for doubtful debts balance of R120,000 relates to specific debtors in respect of which the recovery of the debt is doubtful (2014: 60,000). In the 2014 income tax return, Happy Days correctly claimed a doubtful debt allowance in the amount of R15,000.

Note 4: The breakdown of the prepayments balance is as follows: R80,000 relates to the prepayment (for March 2015) of a monthly service fee customer information security; R12,500 relates to the prepayment (for March 2015) of a monthly insurance premium to insure against business risks. The 2014 prepayments balance was R Nil.

Note 5: The breakdown of the provisions balance is as follows: Provision for staff bonuses is R430,000 (2014: 330,000); Provision for leave pay is R70,000 (2014: 80,000). It is Happy Days' policy to pay out staff bonuses and leave pay two months after year end.

Note 6: Other payables consist of unconditional liabilities that relate to expenditure that is deductible in terms of section 11(a) of the Act.

Note 7: The computer software was self-developed by Happy Days in order to facilitate the online shopping platform. The amortisation expense of R28,440 was recognised up until the date of disposal of the computer software (see Note 12). The cost of computer software developed in the 2015 year of assessment was R10,400 and was incurred on 1 March 2014.

Note 8: Consulting fees amounting to R45,000 were paid to Legal (Pty) Ltd with regard to their review of the share sale agreement in respect of the acquisition of the 100% interest in Goodies.

Note 9: You may assume that section 11(e) wear and tear and depreciation in respect of furniture and fittings are calculated at the same rate and that such rate is acceptable for tax purposes.

Note 10: A cash donation of R15,000 was made to a registered public benefit organisation. However, no section 18A receipt was received from the organisation.

Note 11: The interest expense of R152,000 relates to interest charged on the loan from SA Bank. The loan was raised in order to fund the acquisition of 100% of the equity shares in Goodies. (You may assume that the method used to calculate the interest is in accordance with section 24J).

Note 12: The R200,000 accounting profit on distribution of assets relates to the computer software that was self-developed by Happy Days and the ownership and copyright in the software was transferred to GiftsUK as a distribution *in specie.* This was as a result of a new company policy that required all intangible assets to be owned by the holding company with the subsidiaries paying a monthly fee for the right of use thereof. The directors' resolution provided that the distribution must occur on 28 February 2015 and no reduction of contributed tax capital was elected. Legal transfer of the asset took place on the same day. At the date of distribution, the total capitalised cost of developing the computer software was R250,000 and accumulated amortisation amounted to R150,000. The market value (fair value) of the computer software at the date of distribution was R300,000. You may assume that no Secondary Tax on Companies ('STC') credits were available and that the required exchange control approval was obtained.

Note 13: The unrealised foreign exchange loss is as a result of the non-interest bearing loan from GiftsUK, denominated in pounds sterling. GiftsUK funded the loan using cash reserves from its trading operations. Happy Days has not entered into any foreign exchange contracts or foreign currency option contracts to hedge the loan.

Note 14: You may assume that all 'other operating expenses' are deductible in terms of section 11(a) of the Act.

Part Two **Weight 30**

*Amounts indicated per question is a percentage weighted scale of the total paper weight. This is an indication of how much time you spend on Part Two.

ABC (Pty) Ltd ('ABC') recently acquired all the equity shares in DEF (Pty) Ltd ('DEF'). The purchase price agreed between ABC and the seller, QRS (Pty) Ltd ('QRS'), in respect of this acquisition was R21 million. ABC did not have the funds to settle the purchase price in cash and therefore the share sale occurred on loan account.

DEF holds a 70% interest in XYZ (Pty) Ltd ('XYZ'). The remaining 30% is held by Newco Ltd ('Newco') (20%) and Mrs Smith (10%).

ABC is considering the following transaction steps in order to settle its indebtedness to QRS:

Step 1: XYZ draws on various cash resources in order to accumulate cash of R20 million;

Step 2: XYZ provides DEF with an interest-free loan of R20 million;

Step 3: DEF declares and pays a cash dividend to ABC of R20 million;

Step 4: ABC issues additional ordinary shares and receives R1 million from the equity raise; and

Step 5: ABC then uses the cash received (R20 million plus R1 million) to settle the loan from QRS.

With regard to Step 1 above, XYZ would draw on the following cash resources in order to fund the R20 million interest-free loan to DEF:

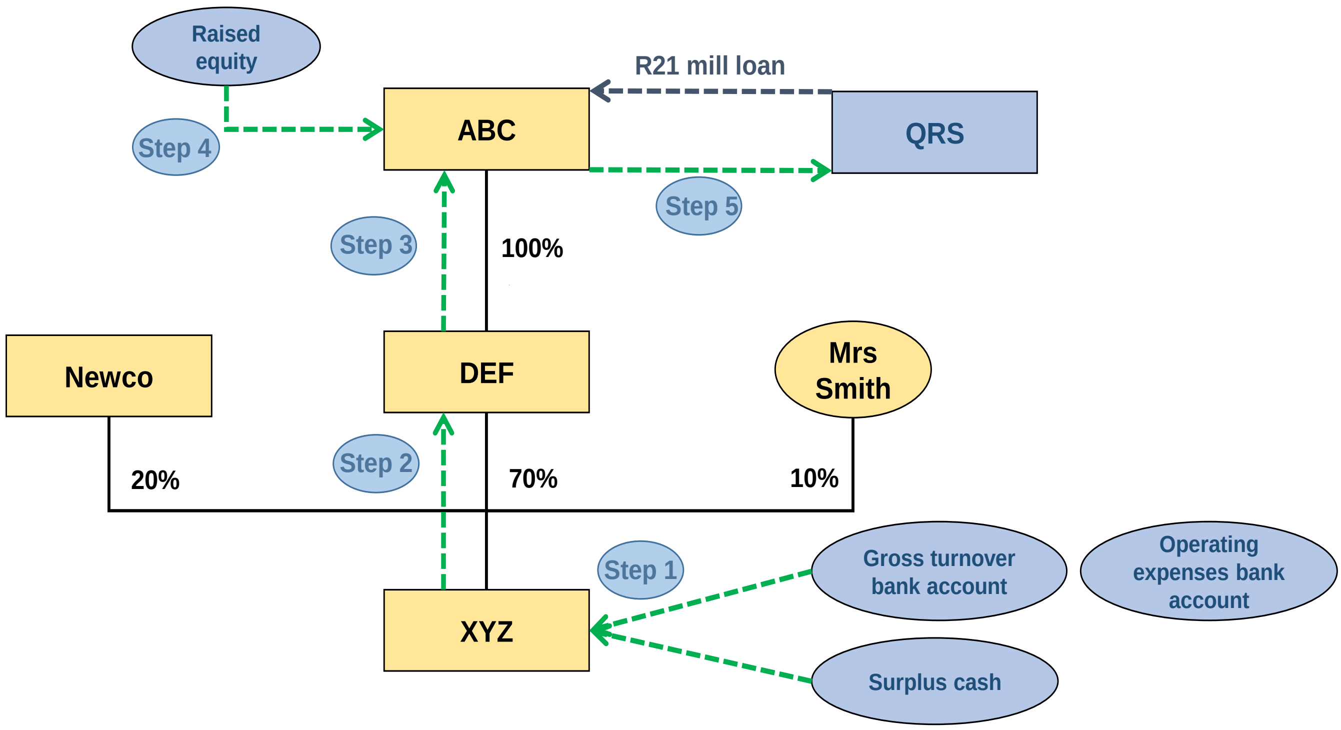
- R10 million from surplus cash; and
- R10 million from a 'gross turnover bank account'.

Further details regarding the 'gross turnover bank account' referred to above, are as follows:

- The 'gross turnover bank account' is a new account that XYZ would create to ring-fence gross revenues. No operating costs would be expensed to this bank account.

- The operating costs referred to above would be expensed from a separate bank account, referred to as the 'operating expenses bank account'. XYZ's bank (SA Bank) is to provide XYZ with a working capital overdraft facility in order to finance these operating expenses.
- The working capital facility would be used to finance operating costs which would be tax deductible as such expenditure would be incurred in the production of income for XYZ.
- The working capital facility from SA Bank is interest-bearing.

The group structure and the various steps referred to above, are depicted below:



For purposes of this case study you may assume the following:

- All persons involved in the transactions described above, meet the definition of 'resident' in section 1(1) of the Income Tax Act No. 58 of 1962 ('the Act').
- ABC acquires the shares in DEF as capital assets and will continue to hold them as such.
- You may ignore Value-Added Tax ('VAT') and you need not address any implications in terms of the Tax Administration Act No. 28 of 2011.

REQUIRED

Part One   Weight 70

*Amounts indicated per question is a percentage weighted scale of the total paper weight. This is an indication of how much time you spend on Part One.

Part One Required		Weight
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.	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. *Presentation*	7 1
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). *No calculations are required, but references to the most relevant sections of the Act should be given to support your explanations.*	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.* *Presentation*	7 1

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.*	15
f	With reference to Note 14, briefly explain whether the unrealised foreign exchange loss is deductible for normal tax purposes. *No calculations are required, but references to the most relevant sections of the Act should be given to support your explanations.*	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**. *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.*	14
h	Based on the information provided, please identify and explain 1 potential tax risk that the financial director of Happy Days should be aware for the 2016 year of assessment.	2

Part Two **Weight 30**

*Amounts indicated per question is a percentage weighted scale of the total paper weight. This is an indication of how much time you spend on Part Two.

Part Two Required		Weight
a	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 her specific queries as follows: i. Briefly explain the income tax implications of Step 4 for ABC. ii. Briefly explain the income tax and dividends tax implications of Step 3 for ABC. iii. Briefly explain the income tax implications Step 2 for DEF. 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. *v.* With reference to Step 2, briefly discuss whether XYZ could consider paying DEF the R20 million cash as a dividend rather than as an interest-free loan. *Presentation*	23 3
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’. Briefly explain your reason(s) for highlighting this as a risk.	4
Total Weight		30