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UNIVERSITY OF JOHANNESBURG

South African Taxation 4

FINAL ASSESSMENT OPPORTUNITY

2 November 2015

TIME: 150 Minutes **MARKS: 100**

EXAMINER: Mr. M Hassan

INTERNAL MODERATOR: Mrs. M Van Heerden

EXTERNAL MODERATOR: Mr. P Nel

INSTRUCTIONS TO CANDIDATES

1. This paper consists of 11 pages
2. Answer all the questions.
3. Thirty minutes of reading time is given for the paper. The duration of the assessment is 2 hours 30 minutes.
4. During the 30 minutes reading time you may:
   - highlight the information presented in this document; and
   - make such annotations on this document as you consider appropriate; and
   - at the close of the 30 minute period you will be given the stationery packs.
5. You are reminded that answers may **NOT** be written in pencil. **No** tippex may be used.
6. The marks shown against the requirement(s) for every question should be regarded as an indication of the expected length and depth of your answer.
7. Answer the questions by the use of:
   - effective structure and presentation;
   - clear explanations;
   - logical arguments; and
   - clear and concise language.
8. Show all calculations clearly
9. Any open spaces that are not crossed out will prohibit a student from applying for a remark.

QUESTION 1 **(75 MARKS)**

This question consist of three related parts.

PART A **(45 MARKS)**

Marco Vernitti, a South African resident, aged 57, is employed as the financial director of 'Martini Limited' (Martini), a South African company and registered VAT vendor. Marco is married to Maria, a housewife, aged 42. They have two children, a son named Richard, aged 30, who is a medical doctor and a resident in the United Kingdom and Grant, aged 16, who is in Grade 10. Richard rarely visits his parents. None of the above individuals has a 'disability' as defined in the Income Tax Act.

In addition to his cash remuneration, Marco received a number of non-cash benefits for his 2015 year of assessment in respect of services rendered to Martini:

1. Marco received a travel allowance of R8 000 per month. Up until 28 February he drove a Ferrari that had cost him R900 000 (including VAT but excluding finance charges) which he purchased on 1 July 2011. He kept a logbook and travelled a total of 26 000 km in the car for the year, of which 10 000 km related to business trips. Martini pays for all fuel in respect of the vehicle and Marco pays for all maintenance, license, insurance and finance costs. In terms of General Binding Ruling No.23 recipients who are provided with principal-owned petrol or garage cards are regarded as having "borne the full cost of the fuel" if the full amount expended on that card during the year of assessment is included in the recipient's travel allowance and is taxed as remuneration. In these circumstances, a recipient will be entitled to claim the "fuel cost" element as a deduction against the travel allowance. The associated costs for the car for the current year is as follows (including VAT where applicable):

Expense	**Paid By**	**R**
Fuel costs	Martini (the amount is included in the annual travel allowance that Marco received)	18 000
Maintenance costs	Marco	22 000
License and insurance costs	Marco	54 000
Finance costs	Marco	110 000

On 28 February 2015 Marco sold the Ferrari for R940 000.

2. Although she is not an employee of Martini, Martini gave Maria the right of use of a BMW 320i that had cost R240 000. Maria had the use of this car throughout the year. Maria had to pay all maintenance costs and half the cost of all fuel. The total cost of maintenance was R12 000 for the year and the total fuel costs were R14 000 (for Martini and Maria) for the year. Maria kept a logbook and travelled 12 000 km during the year of assessment.

3. On 1 May 2014, Martini gave Marco an interest-free loan of R1 million. Marco used half of this loan to buy shares in a UK company (he holds five percent of the issued share capital) and the other half to invest in a South African property real estate investment trust (REIT). The UK Company is not a 'controlled foreign company' for purposes of section 9D.

   Marco received dividends of £1 000 (after withholdings tax of five percent) from the UK company. Marco has elected to use the average rate for the year, which was R18= £1.

   The REIT paid Marco dividends of R25 000 for the year.

   The full amount of the loan was still outstanding at 28 February 2015. You may assume that the official rate of interest remained constant at seven per cent throughout the 2015 year of assessment.

4. On 1 December 2013, Marco was awarded the right to subscribe for shares in Martini. The terms of the offer were that Marco could subscribe for 1 000 shares each year for three years, on the annual anniversary of the offer. Once he exercises his right and acquires a parcel of 1 000 shares, he cannot dispose of them for a period of one year from the date of acquisition thereof. The offer is not in terms of a 'broad-based employee share plan' subject to section 8B.

   On 1 December 2013 Marco exercised his right and acquired 1 000 shares at R5 per share. The market price of the shares on that date was R8 per share. On 1 December 2014, when the market value of the shares was R11 per share, he acquired his second parcel of 1 000 shares for R5 per share. On 1 January 2015 he sold his first parcel of 1 000 shares for R14 per share.

5. During the year, Martini settled a debt of R3 200 that Marco owed to The City of Cape Town.

6. Maria and Grant are registered as dependants on Marco's medical aid. Martini contributed R1 200 per month from March up to and including November 2014 and R1 500 per month for the remainder of the 2015 year of assessment, towards medical aid subscriptions in respect of Marco. Marco also contributed R1 000 per month towards these subscriptions for the entire year. Martini also paid medical expenses of R5 000 (none of which were recoverable) in respect of an illness suffered by Maria. Marco paid total medical expenses (none of which were recoverable) of R10 000 for the year.

7. Marco's cash salary was R150 000 per month for the entire year. Marco contributed ten per cent of this amount to a staff pension fund and Martini contributed an equal amount to the fund.

8. On 1 January 2015, Marco was paid a non-pensionable cash performance bonus of R200 000 by Martini.

9. Marco is bringing forward an assessed capital loss of R25 000 from his 2013 year of assessment. He made no capital gains or capital losses in his 2014 year of assessment, but made a capital gain of R6 000 during his 2015 year of assessment on the sale of a dormant property.

REQUIRED		**Marks**
(i)	Calculate Marco's normal tax liability for his 2015 year of assessment (show all amounts that are to be carried forward to his 2016 year of assessment). Where you are of the opinion that an accrual or expense has no tax effect, provide brief reasons to support your answer.	40
(ii)	Calculate the VAT effects of items (2) and (5) above for Martini for its year of assessment ended 28 February 2015. Your solution should include brief reasons for the VAT effects, even in instances where there is no VAT effect.	5

(Source: QSAT)

PART B **(25 MARKS)**

Marco intends forming a trust in South Africa. Maria is also a resident in South Africa. Marco and Maria are married out of community of property. The trust will be named the 'M&M Family Trust' and the beneficiaries will be Marco, Maria and their two children, Richard and Grant. The trust deed will provide that none of the beneficiaries will have a vested right to the capital or the income of the trust. Distributions from the trust will be at the discretion of the trustees. The trustees will be Marco and Affordable Accounting Solutions CC. Marco makes use of Affordable Accounting Solutions CC for accounting services. Marco will transfer an amount of R750 000 to the trust.

Affordable Accounting Solutions recommends that half of the trust funds be invested in an interest bearing investment and half in equities. It is estimated that the interest yield will be six per cent *per annum.* Dividend yield is estimated to be five per cent *per annum* and capital appreciation in equities is estimated to be seven per cent *per annum*. After costs relating to the formation of the trust, it is estimated that there will be a sum of R40 000 from the return of investments to be held in the trust annually. The equities and interest bearing investments are all of a South African source.

Analysis of estimated trust income after taking into account trust expenses of R1 250:

Trust income	**Total (R)**	**%**
Interest	22 000	55%
Dividends	18 000	45%
Total	**40 000**	**100%**

	Total (R)	**Interest (55%) (R)**	**Dividends (45%) (R)**
Retained in the trust	40 000	22 000	18 000

REQUIRED		Marks
(i)	Advise Marco, supported with references to legislation, on the tax implications (donation tax and estate duty) of: a) Marco donating the R750 000 to the trust; and b) Marco transferring the R750 000 interest-free into the trust by way of a loan account.	9
(ii)	Discuss, how the interest and the dividends received and retained by the trust will be taxed where the amount (i.e. the R750 000) is loaned to the trust with market-related interest charged.	4
(iii)	Discuss, supported with references to legislation and case law, how the interest and the dividends received by the trust will be taxed if instead of retaining the amounts in the trust the trustees apply their discretion and vest R20 000 each to Richard and Grant where the initial amount (i.e. the R750 000) is loaned to the trust interest free. Assume the full R40 000 is vested.	12

PART C **(5 MARKS)**

Marco came across the following article which appeared in the Mail and Guardian on 06 July 2015 and began to think about the tax implications of a golden handshake should Martini ever make a lump sum payment to him in this form.

"Government pays out millions in golden handshakes

The Department of Agriculture, Forestry and Fisheries and its entities have paid over R6-million in golden handshakes since the 2008/09 financial year, while entities under finance, social development and transport ministers have managed to fork out almost R50-million to make employees go away.

In most government entities, suspension over issues such as dereliction of duty, breakdown in employee and employer relations and misconduct leads to millions in payouts, a fact which has been brought to the forefront through a range of written questions by Democratic Alliance MPs over the past month.

Transport Department entities have also paid out millions to staff for misconduct, poor performance and termination of contracts.

In a reply to Parliament, the department said Passenger Rail South Africa has paid out more than R16-million to various employees from 2008 to the 2014/15 financial year, for breakdown of trust. A payout of more than R7-million was made to its Group Executive Legal Mateboga Nkoenyane over operational restructuring and a mutual consent package."

REQUIRED	**Marks**
Discuss the income tax implications of a golden handshake supported with reference to legislation on the assumption that the golden handshake does not meet the definition of a "severance benefit" in section 1 of the Income Tax Act.	5

QUESTION 2 **(25 MARKS)**

You are currently involved in the completion of the tax review of Leisure Living Ltd for its financial year ended 28 February 2015. The company manufactures mobile homes and caravans, which are marketed and sold locally. In addition, from time to time it invest surplus funds in dividend-yielding investments. The company is incorporated, managed and controlled in South Africa.

As the senior member of the tax team, the client has requested that you assist in computing the income tax liability of Leisure Living Ltd for the year ended 28 February 2015.

The company has always had a February year end.

Set out below is the abridged statement of comprehensive income of Leisure Living Ltd for its financial year ended 28 February 2015 as well as additional information obtained during the course of your tax review.

ABRIDGED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 28 FEBRUARY 2015

	Additional information	**R**	**R**
Revenue			4 165 000
Cost of Sales			(2 397 000)
Gross Profit			1 768 000
Sundry Income: • Dividends • Interest	1	12 820 12 180	25 000
			1 793 000
Manufacturing overheads, administrative expenses	2		(1 032 500)
Net profit before interest and tax			760 500
Less: Interest expense - First Union Bank	3		(84 500)
Net profit before tax			**676 000**

ADDITIONAL INFORMATION:

1. **The following dividends accrued to Leisure Living (Pty) Ltd:**

	R
Subsidiary – Tip Top Investments (Pty) Ltd	4 500
Listed companies	4 770
Equity unit trusts	3 550
	12 820

The “dividends” from equity unit trusts (collective investment scheme in securities) comprise dividends of R2 550 and interest R1 000.

2. **The following amounts have been included in the manufacturing overheads and administrative expenses of R1 032 500:**

2.1 Bad debt expense – R37 220

	R
Trade accounts receivable of Leisure Living Ltd written off	22 220
Staff loan written off	5 000
Increase in provision for doubtful debts	10 000
	37 220

The doubtful debt provision at 28 February 2014 was R80 000. A schedule of all debts that are doubtful is provided to the Commissioner for SARS each year and he allows and allowance of 25% thereof.

2.2 Insurance premiums – R 50 000

Leisure Living Ltd started paying its insurance premiums in advance from 1 February 2015. Prior to that date, Leisure Living Ltd paid its insurance premiums on a monthly basis. For the period 1 March 2014 to 1 February 2015, the company paid R40 000 (VAT exclusive). A prepayment of R120 000 (VAT exclusive) for the period 1 February to 31 January 2016 was made on 1 February 2015, and R10 000 expensed.

2.3 Depreciation – R152 500

Fixed asset register:

Asset	**Cost** **R**	**Current depreciation** **R**	**Book value 28/2/2015** **R**
Land	150 000	-	150 000
Factory building	620 000	25 500	505 500
Office building	622 000	34 700	478 300
Plant and machinery	860 000	86 000	559 000
Furniture and fittings	63 000	6 300	28 350
Total	**2 315 000**	**152 500**	**1 721 150**

The construction of the factory buildings and administration offices commenced on 1 July 1996. Both buildings were completed on 30 October 1996 and occupied for the purposes of trade with immediate effect. The buildings were not constructed on the same site.

The cost of plant and machinery used in the manufacturing process, as defined, is made up of the following items exclusive of VAT:

- Machine A (second-hand):
  Cost – R136 000
  Acquired in January 2011
  Brought into use for the first time in February 2011

- Machine B (new)
  Cost – R225 000
  Acquired in June 2011
  Brought into use for the first time in the next month

- Machine C (new)
  Cost – R144 500
  Acquired in December 2014
  Brought into use for the first time in January 2015

- Sundry assets
  Cost – R354 500
  Acquired during the early 1990's
  Fully written off for income tax purposes

The financial accountant has produced, for income tax purposes, a calculation of the capital allowances available on the furniture and fittings, which you have checked and found to be correct. This calculation shows a wear and tear allowance of R10 500.

2.4 Fines and penalties – R8 400

For speeding to get to business meetings on time and penalties in respect of delayed payment for these fines as a result of poor administrative attention.

2.5 Warranty expense – R 128 640

Leisure Living Ltd offers a five-year warranty on all products sold. Based upon historical data the company raises a warranty provision at the end of each year financial year to reflect the potential future liability of the company for warranty expenses on products that have been sold and are still covered by the warranty provision.

If incurred, warranty expenditure is debited to the warranty provision account. A reconciliation of the warranty provision is as follows:

	R
Balance at 28 February 2014	158 070
Warranty expenditure incurred	(60 000)
Increase in provision	128 640
Balance at 28 February 2015	**226 710**

3. **Interest expense - First Union Bank**

This interest has been incurred on a loan from First Union Bank. The loan was taken out in order to fund the acquisition of shares in a subsidiary – Tip Top investments (Pty) Ltd, a South African company. The only income Leisure Living Ltd earns for the subsidiary is dividend income.

REQUIRED	**Marks**
Calculate the taxable income of Leisure Living Ltd in respect of the financial year ended 28 February 2015. Start your calculation with the net profit before tax figure of R676 000. Where you are of the opinion that an accrual or expense has no tax effect, provide brief reasons to support your answer.	25

(Source: SAICA abridged)