

Tutorial letter 201/2/2014

Principles of Taxation

TAX2601

Semester 2

Department of Taxation

QUESTIONS AND SUGGESTED SOLUTIONS

ASSIGNMENT 3 (exam paper)

Bar code

Dear Student

This tutorial letter contains assignment 3, which is the questions and solutions for a previous exam paper. This assignment is not compulsory; however, it will assist you in your preparation for the exam. The solution for Assignment 1 will be provided in tutorial letter 202 and the solution for assignment 2 will be provided in tutorial letter 203.

Best wishes for your preparation for the exam.

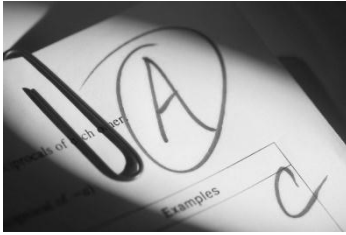
Kind regards

TAX2601 Lecturers

| | |
|--|--|
| Telephonic contact with lecturers: | |
| The lecturers who are available to assist you are: Prof AP Swanepoel Ms MSI Wentzel Ms R Matenche Ms C Cass Ms C Stedall Mr A Swanepoel Mr M van Dyk Ms R Moosa Ms N Thoothe Ms E Doussy | 012 429 4133 (this is a hunting line – you will need to let it ring so that the exchange can find a free extension) |
| Departmental cell phone number: | 079 365 1124 |
| E-mail contact with lecturers: | TAX2601-14-S1@unisa.ac.za (semester 1) TAX2601-14-S2@unisa.ac.za (semester 2) Course contact tab on <i>myUnisa</i> |
| Fax numbers: (Department of Taxation) | 012 429 4902 or 012 429 4443 |

Ms P Mohase (Administrative assistant)

012 429 4918



This assignment is based on an examination paper. This is a self-assessment assignment.



These are the instructions that will also appear on your examination paper. Read them now and make sure that you understand what we require from you. We also suggest that you try to do this assignment like a proper examination, under examination conditions, to see how much you know and what you need to spend time on.

This paper consists of six (6) pages plus the annexures (pp i – iii).

IMPORTANT INSTRUCTIONS:

Assumptions:

1. **All amounts exclude VAT unless stated otherwise.**
2. **All persons mentioned are residents of the Republic of South Africa unless stated otherwise.**
3. **SARS = South African Revenue Service**

The answering of this paper:

1. This paper consists of five (5) questions.
2. Answer all the questions.
3. Start each question on a new (separate) page.
4. **Show all workings, where applicable. Where an amount is subject to a limitation, clearly indicate the application of the limitation. Where any item is exempt from tax or not allowable as a deduction, this must be indicated. All amounts must be rounded to the nearest rand.**
5. Please complete the cover page of the answer book in full.
6. You are reminded that answers may **NOT** be written in pencil.
7. Proposed timetable (**try as far as possible not to deviate from this timetable**):

| Question | Topic | Marks | Minutes |
|----------|--|------------|------------|
| 1 | Gross income and general deduction | 25 | 30 |
| 2 | Provisional tax and tax administration | 15 | 18 |
| 3 | Taxable income of a small business corporation | 25 | 30 |
| 4 | Tax liability of a company | 20 | 24 |
| 5 | Capital gains tax | 15 | 18 |
| | TOTAL | 100 | 120 |

QUESTION 1 (25 marks, 30 minutes)**QUESTION 1(a) (10 marks, 12 minutes)**

Dinepe Fela (Pty) Ltd (Dinepe) is a South African company that sells contemporary art. Dinepe's financial year ends on 31 March. On 28 March 2014 they sold an artwork worth R10 000 to an advertising company. The advertising company bought the artwork to hang in their reception area. Instead of paying cash for the artwork, the advertising company offered Dinepe an advertising campaign also worth R10 000. On 30 March 2014, Dinepe accepted the advertising campaign instead of cash. The campaign would consist of 10 monthly advertisements in a local newspaper, commencing during April 2014.

| REQUIRED: | MARKS |
|--|--------------|
| Discuss whether the receipt of the advertising campaign would constitute gross income of Dinepe Fela (Pty) Ltd as defined in the Income Tax Act 58 of 1962 for the year ending 31 March 2014. | 10 |

QUESTION 1(b) (15 marks, 18 minutes)

Dikoloto Fela (Pty) Ltd (Dikoloto) is a residential property developer with a March year-end. Dikoloto's main business is selling residential property in the form of freestanding full-title homes, sectional title townhouses and full-title stands.

On 13 October 2013, hurricane Sally struck one of the towns in which Dikoloto operates and destroyed four unsold townhouses with an original cost of R4 500 000 in total. The insurance company paid Dikoloto R3 900 000 in respect of this loss.

| REQUIRED: | MARKS |
|---|--------------|
| Discuss whether the expenditure and/or losses above are deductible by Dikoloto Fela (Pty) Ltd in terms of the general deduction formula (s 11(a) read with s 23) for the year of assessment ending 31 March 2014. Where applicable, briefly make reference to the applicable case law. | 15 |

QUESTION 2 (15 marks, 18 minutes)**QUESTION 2(a) (10 marks, 12 minutes)**

Sunshine (Pty) Ltd is **not** a small business corporation as defined. Its year of assessment ends on 31 March each year. Its records show the following:

| Tax year | Taxable income | Date of assessment |
|----------|----------------|--------------------------------|
| 2012 | R1 200 000 | 4 April 2013 |
| 2013 | R1 354 980 | 15 September 2013 |
| 2014 | R1 784 432 | (estimated - not yet assessed) |

| REQUIRED: | MARKS |
|---|----------|
| a) Calculate the first and second provisional tax payments for the 2014 year of assessment. Clearly state on which date the payment must be made. | 9 |
| b) For the first provisional tax payment for the 2014 year of assessment, what will the basic amount be if the 2013 assessment was issued on 15 June 2013? | 1 |

QUESTION 2(b) (5 marks, 6 minutes)

Majuba (Pty) Ltd was issued its 2013 ITA34 tax assessment on 31 January 2014. The accountant of Majuba (Pty) Ltd has reviewed the issued assessment and disagrees with the disallowance of a capital allowance claimed of R15 500. The ITA34 reflects an amount of R6 875 due to SARS, payable on/before 31 March 2014. The accountant submitted an objection against the issued tax assessment on 4 February 2014 and SARS declined the objection on 15 March 2014.

| REQUIRED: | MARKS |
|--|----------|
| Discuss what procedures, if any, Majuba (Pty) Ltd can follow to rectify the incorrect 2013-tax assessment. | 5 |

QUESTION 3 (25 marks, 30 minutes)

Lazy Age CC is a small business corporation as defined and carries on business as a cosmetics product manufacturer. The close corporation operates mainly in Johannesburg and sells most of its cosmetics products on credit to retailers in South Africa. It has only one member, Jenny Levin.

The following information is provided to you for the close corporation's year of assessment ended 28 February 2014:

| | R |
|---|-----------|
| 1. Sales – cash | 450 000 |
| Sales – credit | 5 025 000 |
| 2. Purchases – cash and credit | 3 587 150 |
| 3. Inventory at cost – 1 March 2013 | 290 000 |
| 4. Inventory at cost – 28 February 2014 | 330 000 |
| 5. Bad debts written off | 119 000 |
| 6. Doubtful debts allowance, allowed by SARS for the 2013 year of assessment | 12 500 |
| 7. List of doubtful debts at 28 February 2014 | 93 800 |
| 8. Personnel costs: | |
| - Salaries and wages (as approved by the Commissioner) | 650 000 |
| - Contributions to pension fund on behalf of employees | 125 850 |
| 9. On 30 April 2013, Lazy Age CC received a letter from Quick Attorneys regarding alleged facial damages caused by one of its night creams to the upper cheek of Amy Kumalo, a super model for Paris on the Vaal. She is claiming R1 500 000 for a loss of income from Lazy Age CC. The case went to court and the court ordered Lazy Age CC to pay Amy R1 000 000 for her loss of income on 31 March 2014. | |
| 10. Legal expenses incurred: | |
| - Legal cost relating to the Amy Kumalo case (refer note 9) | 6 000 |
| - Legal cost paid on behalf of Jenny Levin | 1 275 |
| 11. Advertising cost: | |
| - Cost of advertising a vacant post in the <i>Daily Informer</i> | 3 750 |
| - Cost of erecting a billboard close to the local airport | 25 850 |
| 12. Lazy Age CC owns the following capital assets: | |
| - A new cosmetics manufacturing machine D was purchased on 31 January 2014 at a total cost of R300 000 and was brought into use on the same date. | |
| - A second-hand delivery vehicle was purchased on 31 July 2012 at a total cost of R85 000 to deliver the cosmetics products of Lazy Age CC to its clients. The delivery vehicle was only brought into use on 1 September 2012. | |
| - A manufacturing building was erected on 30 June 2010 and brought into use on 31 August 2010 at a total cost of R1 250 000. The building houses the whole cosmetics manufacturing process of Lazy Age CC. | |
| 13. Lazy Age CC sold technologically outdated manufacturing machinery Z for R20 000. It was originally bought second-hand on 30 April 2010 for R100 000 and brought into use on the same day. | |

QUESTION 3 (continued)

| | R |
|--|--------|
| 14. The following costs were incurred relating to trademarks: | |
| - Renewal fee paid in 15 April 2013 | 8 500 |
| - New trademark purchased on 31 January 2014 | 55 000 |
| 15. Lazy Age CC entered into an agreement with Tommy Strong, the former chemical researcher, on 31 October 2013 (the date on which he resigned) and paid him an amount of R312 000 as a restraint of trade payment for a period of four years. The R312 000 was paid on 15 November 2013 and the full amount was taxable in Tommy's hands for the 2014 year of assessment. | |
| 16. Lazy Age CC donated R15 000 on 15 December 2013 to "Ladies in Blue" a public benefit organisation uplifting women in the rural areas. The necessary section 18A income tax certificate was received on 17 January 2014. | |

| REQUIRED: | MARKS |
|--|-------|
| Calculate the taxable income of Lazy Age CC for the year of assessment ended 28 February 2014. Ignore any capital gains tax implications. | 25 |

QUESTION 4 (20 marks, 24 minutes)

Notes CC carries on the business of manufacturing music instruments. It is **not** regarded as a small business corporation as defined in the Income Tax Act.

The taxable income of the close corporation for the year of assessment ending 31 March 2014, **before** taking into account the items mentioned below, amounted to R5 800 000.

Additional information:Fixed assets obtained in prior years and still in use at 31 March 2014:

- Vehicles: purchased new on 1 June 2008 for R120 000.
- Building CC in an urban development zone: purchased new on 1 November 2012 for R1 200 000. All the requirements to claim an urban development zone building allowance were met.

Fixed assets obtained during the year:

- Two small item assets with a collective cost of R4 500 were purchased on 30 November 2013. These items qualify for the section 11(e) wear and tear allowance.
- Manufacturing machine MM was purchased second-hand on 1 June 2013 for R300 000 and brought into use on the same date.
- A new manufacturing machine LL was purchased on 1 February 2014 for R450 000 and brought into use on 1 March 2014.

QUESTION 4 (continued)

6. Manufacturing building AA was sold on 1 January 2013 for R5 000 000 and Notes CC had a recoupment of R800 000. It purchased a new manufacturing building ZZ for R9 000 000 on 1 April 2013 and brought it into use on the same date. The cost was made up as follows:

| | |
|----------|--------------------|
| Land | R1 000 000 |
| Building | <u>R9 000 000</u> |
| Total | <u>R10 000 000</u> |

Repair and extension to assets:

7. Manufacturing building ZZ's roof was badly damaged during a storm and needed to be replaced on 1 April 2013 at a cost of R220 000. Notes CC decided to extend the roof to allow for an undercover parking area for its employees. The cost of this extension amounted to R300 000.

Fixed assets sold during the year:

8. On 31 March 2014 furniture, costing R30 000 and originally purchased on 1 October 2012, was sold for R10 000. The furniture was sold to a pawnshop because it was damaged and was no longer useable. No transactions regarding this asset have been included in the taxable income calculation of R5 800 000 above.
9. On 30 November 2013 manufacturing machine PP costing R290 000 was sold for R310 000. This machine was purchased new on 30 June 2007. No transactions regarding this asset have been included in the taxable income calculation of R5 800 000 above.

Other information:

10. Binding general ruling No. 7 makes provision for the following write-off periods:
- Vehicles – 5 years
 - Undercover parking (carports) – 5 years
 - Furniture – 6 years

| REQUIRED: | MARKS |
|--|--------------|
| Calculate the income tax liability of Notes CC for the year of assessment ending 31 March 2014. Note: The close corporation has elected to claim the section 11(o) allowance of the Income Tax Act, and to make use of the building recoupment set-off, where applicable. Ignore any capital gains tax implications. | 20 |

QUESTION 5 (15 marks, 18 minutes)

Frozen Lemons CC has a 31 March year-end. The business supplies you with the following information regarding a manufacturing building:

| Date | Descriptions | Amount |
|--------------|--|---------------|
| | | R |
| 1 July 2000 | Purchased | 80 000 |
| 1 April 2013 | Sold – to an unconnected person, at market value | 890 000 |

| | | |
|-------------------------------------|---|--------|
| Other applicable information | Valuation on 1 October 2001 | 88 000 |
| | Time-apportioned base cost | 90 000 |
| | Cost of valuation (carried out on 1 July 2003) | 4 500 |
| | Capital allowances at date of sale | 48 000 |
| | Assessed capital loss brought forward from 2013 | 30 000 |

| REQUIRED: | MARKS |
|--|--------------|
| Calculate the taxable capital gain for the 2014 year of assessment in respect of the sale of the manufacturing building. | 15 |

SOLUTION**QUESTION 1(a) (10 marks)**

| Definition | Application | Marks |
|---|---|--------------|
| In the case of a resident, amounts in cash or otherwise | Dinepe is a resident (South African) company that received an advertising campaign (satisfies the “otherwise” of gross income definition) in return for their artwork, since a value can be placed on it. | (3) |
| Received by or accrued to such a resident | Dinepe is unconditionally entitled to an advertising campaign therefore it has accrued to Dinepe / or for own benefit. | (2) |
| During year of assessment | The artwork was sold on 28 March 2014 and Dinepe accepted the advertising instead of the cash on 30 March 2014 therefore falling in the period of assessment ending 31 March 2014. | (2) |
| Excluding receipts or accruals of a capital nature | Dinepe is in the business of selling contemporary art (its trading stock) thus the accrual of an advertising campaign is not capital in nature / not enduring benefit. | (2) |
| Conclusion | The requirements of the gross income definition have all been met therefore the receipt of the advertising constitutes gross income of Dinepe Fela (Pty) Ltd for the period ending 31 March 2014. | (1) (1) |

Max 10**QUESTION 1(b) (15 marks)**

| Definition | Application | Marks |
|-------------------------------|---|-------------------|
| Carrying on of Trade | Dikoloto is carrying on a trade of developing residential property | (2) |
| Expenditure or loss | A loss of R4 500 000 has been incurred | (2) |
| Actually incurred | With the storm destroying the houses completely, a loss equivalent to the cost was actually incurred | (2) |
| During the year of assessment | The storm took place on 13 October 2013 and the loss was subsequently incurred thus falling in the current year of assessment | (2) |
| In the production of income | The erection of houses is the trading stock of the company, therefore their destruction would be closely linked to the production of income / inevitable concomitant | (2) |
| Not of a capital nature | The houses are the trading stock of the company and therefore the loss is of a revenue nature / no enduring benefit | (2) |
| s23 prohibition | Section 23 (c) prohibits the deduction of an amount that has been recovered. R3 900 000 of the R4 500 000 loss has been recovered from the insurance. Therefore only R600 000 is deductible. | (1) (1) (1) |
| Conclusion | The R4 500 000 loss complies with all the requirements of section 11(a) however R3 900 000 is prohibited from being deducted in terms of section 23. Therefore R600 000 will be deductible in terms of the general deduction formula. | (1) (1) |

Max 15

QUESTION 2(a) (10 marks)

| | | |
|--|------------------|-----|
| a) 1st provisional tax payment (payable on 30 September 2013) | | (1) |
| Basic amount (must use 2013 assessment as it was received more than 14 days before the provisional payment is due) | R 1 354 980 | (2) |
| Tax on R1 354 980 (28%) | <u>379 394</u> | (1) |
| x 50% for the first payment | <u>189 697</u> | (1) |
| 2nd provisional tax payment (payable on 31 March 2014) | | (1) |
| Taxable income is more than R1 million therefore based on estimated taxable income | <u>1 784 432</u> | (1) |
| Tax on R1 784 432 (28%) | 499 641 | (1) |
| <u>Less:</u> 1 st provisional payment | <u>(189 697)</u> | (1) |
| Amount payable | <u>309 944</u> | |
| b) As it is more than 14 days old, the 2013 taxable income will still be used as the basic amount. It will not be adjusted, as it is the previous year's taxable income. | 1 354 980 | (1) |

QUESTION 2(b) (5 marks)

| | |
|---|----------|
| Majuba (Pty) Ltd can lodge an appeal via eFiling or manually to SARS and they will have to pay the outstanding amount of R6 875 to SARS by 31 March 2014. | (2) |
| The appeal will be the same format as the ADR1 with the same information that needed to be provided together with the supporting documentation to be submitted again. | (1) |
| If SARS rejects the appeal, Majuba (Pty) Ltd may take the matter to the Tax board or Tax court first. | (1) |
| If the matter remains unresolved, Majuba (Pty) Ltd could take the matter to the High Court. | (1) |
| The last option available will be to take the matter to the Supreme Court. | (1) |
| Max | 5 |

QUESTION 3 (25 marks)

Calculation of taxable income of Lazy Age CC for the year of assessment ended 28 February 2014

| | R | R | |
|---|-----------|-------------|------------|
| Sales – cash | | 450 000 | (1) |
| Sales – credit | | 5 025 000 | (1) |
| Purchases | | (3 587 150) | (1) |
| Inventory at cost – 1 March 2013 – s22(2) | | (290 000) | (1) |
| Inventory at cost – 28 February 2014 – s22(1) | | 330 000 | (1) |
| Bad debts written off – s11(i) | | (119 000) | (1) |
| Doubtful debts – allowed in 2013 – s11(j) | | 12 500 | (1) |
| Allowance for doubtful debts (R93 800 x 25%) – s11(j) | | (23 450) | (1) |
| Salaries and wages | | (650 000) | (1) |
| Contribution to employee's pension fund – s11(l) | | | |
| (10% x R650 000 = R65 000) | | (65 000) | (1) |
| Damages paid – loss of income (not 2014 year) | | Nil | |
| Legal cost – s11(c)_ | | | |
| - Amy Kumalo's case | | (6 000) | (1) |
| - Jenny Levin – private expense, prohibited (1) | | Nil | |
| Advertising expenses – s11(a) | | | |
| - Cost of advertising in the Daily Informer | | (3 750) | (1) |
| Cost of erecting a billboard – capital, creates and enduring benefit (1) | | Nil | |
| Section 12E allowances: | | | |
| Cosmetic manufacturing machine D (R300 000 x 100%) | | (300 000) | (1) |
| Second hand delivery vehicle (R85 000 x 30%) | | (25 500) | (1) |
| Building allowance – S13(1) (R1 250 000 x 5%) | | (62 500) | (1) |
| Disposal of Machine Z | | | |
| - Cost | 100 000 | | |
| - <u>Less:</u> Section 12E allowance (2011 – 100%) | (100 000) | | (1) |
| - Tax value | 0 | | |
| - Selling price | 20 000 | | (1) |
| - Recoupment – s8(4)(a) | 20 000 | 20 000 | (1) |
| Renewal of trademark - s11(gB) | | (8 500) | (1) |
| New trademark purchased - s11(gC) – no deduction | | Nil | (1) |
| Restraint of trade agreement – s11(cA) (R312 000/4) | | (78 000) | (1) |
| Sub-total | | 618 650 | |
| <u>Less:</u> Donation - s18A - limited to 10% (1) of R618 650 (1) = R61 865 | | (15 000) | |
| Taxable income for 2014 | | 603 650 | |

QUESTION 4 (20 marks)**Calculation of Notes CC's tax liability for the year of assessment ending 31 March 2014**

| | R | R | |
|---|------------------|------------------|-------------|
| Taxable income given | | 5 800 000 | |
| Existing assets | | | |
| Vehicles - s11(e) (R120 000/5 x 2/12) | | (4 000) | (2) |
| Building CC: urban development zone – s13quat (R1 200 000 x 8%) | | (96 000) | (1) |
| New assets | | | |
| s11(e) small items | | (4 500) | (1) |
| Manufacturing machine MM second hand – s12C (R300 000 x 20%) | | (60 000) | (1) |
| Manufacturing machine LL new – s12C (R450 000 x 40%) | | (180 000) | (1) |
| Land (no allowance claimable) (1) | | Nil | |
| Manufacturing building ZZ | | | |
| Cost | 9 000 000 | | |
| <u>Less</u> : recoupment on previous building (s13(3)) | (800 000) | | (1) |
| Cost on which allowance is based | <u>8 200 000</u> | | |
| S13(1) building allowance (R8 200 000 x 5%) | | (410 000) | (1) |
| Repair and extend | | | |
| Repair of roof – s11(d) | | (220 000) | (1) |
| Extend roof for undercover parking – capital nature (1) | | Nil | |
| Capital allowance- s11(e): undercover parking (R300 000/5) | | (60 000) | (1) |
| Assets sold | | | |
| Furniture sold | | | |
| Cost | 30 000 | | |
| <u>Less</u> : wear and tear – s11(e) | | | |
| 2013: R30 000/6 x 6/12 | (2 500) | | (2) |
| 2014: R30 000/6 | (5 000) | (5 000) | (1) |
| Tax value | <u>22 500</u> | | |
| <u>Less</u> : proceeds | (10 000) | | (1) |
| Scrapping allowance – s11(o) | <u>12 500</u> | (12 500) | (1) |
| Manufacturing machine PP sold | | | |
| Proceeds | 310 000 | | |
| <u>Less</u> : Tax value | nil | | (1) |
| Recoupment – S8(4)(a) | <u>310 000</u> | | |
| Limited to previous allowances (R290 000 – nil) | 290 000 | 290 000 | (1) |
| Taxable income | | <u>5 038 000</u> | |
| Tax liability @ 28% | | <u>1 410 640</u> | (1) |
| | | Total | (20) |

QUESTION 5 (15 marks)Calculation of taxable capital gain on manufacturing building

| | R | R | |
|---|----------------|------------------|-----|
| <u>Calculation of adjusted proceeds:</u> | | | |
| 1. Tax value | | | |
| Cost | | 80 000 | |
| <u>Less:</u> capital allowances claimed | | <u>(48 000)</u> | |
| Tax value | | <u>32 000</u> | (1) |
| 2. Recoupment | | | |
| Selling price | | 890 000 | |
| <u>Less:</u> Tax value | | <u>(32 000)</u> | (1) |
| Recoupment | | <u>858 000</u> | |
| Limited to amount claimed previously | | 48 000 | (1) |
| 3. Adjusted proceeds | | | |
| Selling price | | 890 000 | (1) |
| <u>Less:</u> Recoupment | | <u>(48 000)</u> | (1) |
| Adjusted proceeds | | <u>842 000</u> | |
| <u>Calculation of base cost:</u> | | | |
| Valuation date value | | | |
| Expenditure before 1/10/2001 | 32 000 | | |
| Expenditure after 1/10/2001 | <u>4 500</u> | | |
| Total expenditure | <u>36 500</u> | | |
| Proceeds (R842 000) > total expenditure (R36 500), par 26 apply | | | |
| * TAB | | 90 000 | (1) |
| * 20% of proceeds less post 1/10/01 cost (20% x (R842 000 - R4 500)) | | 167 500 | (2) |
| * Market value | | 88 000 | (1) |
| Valuation date value = greatest of three - 20% rule | 167 500 | | |
| Base cost | | | |
| Valuation date value | 167 500 | | |
| <u>Plus:</u> Cost after 1/10/2001 | <u>4 500</u> | | |
| Base cost | <u>172 000</u> | | |
| <u>Calculation of Capital Gain</u> | | | |
| Proceeds | | 842 000 | |
| <u>Less:</u> Base Cost | | <u>(172 000)</u> | |
| Aggregate capital gain | | 670 000 | (1) |
| <u>Less:</u> Assessed capital loss | | <u>(30 000)</u> | (1) |
| Net capital gain | | <u>640 000</u> | |
| Taxable capital gain @ 66.6% | | <u>426 240</u> | (1) |

[15]**Unisa**

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