Errata: Provisional tax calculation – Change in the periods that determine the basic amount (section 3.9.1 in tutorial letter 102)
Currently, the basic amount is deemed to be as follows:

1. The taxable income assessed by the Commissioner, for the” latest preceding year of assessment” less—
   - taxable capital gain included in terms of section 26A

2. The “Latest preceding year of assessment” is deemed to be:
   - the assessment relating to preceding year of assessment
   - where a notice issued by the Commissioner of such an assessment is more than 14 days before the date on which the current period estimate is submitted to the Commissioner

3. If the assessed amount for the latest preceding year of assessment was assessed
   - more than 18 months AND
   - in respect of a period that ends more than one year after the end of such preceding year of assessment,

then the basic amount must be increased by 8% per annum of that assessed amount, from the end of such latest year to the end of the current year of assessment in respect of which the estimate is made.

The 18 month-period refers to the date on which the previous year’s assessment was received up to the date on which the first provisional payment is due. Refer to the timelines provided on page 5 of this document for an illustration of this principle.

STUDY UNIT 1

1. An example of a tax that is levied on income is: Income tax
2. An example of a tax that is levied on consumption is: Customs Duty
3. Taxes can be levied on income or consumption or wealth or other
4. Consumption taxes are taxes that are levied on the: sale or use of commodities
5. Wealth taxes are taxes that are levied on: the transfer of property eg capital gains tax, estate duty, donations tax
6. Other taxes are generally levied on: specific transactions eg transfer duty, marketable securities tax, fuel levy, dividend tax
7. Income tax on natural persons is an example of what method of tax?: Progressive tax
8. There are three methods that can be used to calculate tax, they are: Proportional tax, progressive tax and regressive tax
9. A Direct tax tax is a tax where the same person who earns the income pays the tax
10. Where the seller bears the impact of the tax and the consumer pays, this is known as: Indirect Tax eg. VAT

STUDY UNIT 2

1. A taxpayer has to submit an income tax return if registered as a taxpayer – True
2. Any person (individual, company or trust) who becomes liable for any normal tax at any time should register as taxpayer with SARS within how many days: 21 days
3. Any person may request information from SARS about another taxpayer – False
4. The source document used as the basis for the assessment process is called: **Tax return**

5. The purpose of a tax assessment (ITA34) is: **To indicate the calculation of normal taxable income & to indicate the normal tax for the year of assessment & To indicate the amount of any tax due by or refundable to a taxpayer**

6. Before a taxpayer can lodge an objection a tax assessment should have been issued: **True**

7. When a taxpayer is dissatisfied with the result of the objection, the next step is to go to court: **False**

8. A taxpayer may settle a dispute with the Commissioner when intentional tax evasion or fraud is present in a specific case: **False**

9. An entity like a trust, company or close corporation has to have a representative taxpayer being approved by the Commissioner: **True**

**Study Unit 3**

1. Calculate the tax liability for a small business corporation, as defined, with a taxable income of R89 200.00 = first R67111
   = 0% tax then 7% of amount above R67111 thus R22089 x 7% = R1,546.23

2. What is the tax rate of a company? **28%**

3. If a company has a March year-end, when must the second provisional tax payment be made? **March next year. There are two obligatory provisional tax payments, the first is due on or before the last day of the sixth month of the year of assessment and the second is due on or before the last day of the year of assessment.**

4. What is the tax rate of a close corporation? **28%**

5. Public and private companies qualify as small business corporations – **False** A “small business corporation” is defined in section 12E(4) as any close corporation, co-operative or any private company in terms of the Companies Act and can therefore never be a public company. There are additional requirements that an entity must satisfy for it to be a small business corporation as defined in s12E(4) - please ensure you are familiar with these requirements.

6. In order for a company to be classified as a small business corporation, the definition states that investment income and income from a personal service cannot make up more than 10% of the revenue receipts and capital gains of the company – **False** the answer is 20% - In order for a company to be classified as a small business corporation, the definition states that investment income and income from a personal service cannot make up more than 20% (and not 10%) of the revenue receipts and capital gains of the company.

7. In terms of the Sixth Schedule to the Income Tax Act, a trust cannot qualify as a micro business – **True. In terms of the Sixth Schedule to the Income Tax Act, a trust cannot qualify as a micro business.**

8. In terms of turnover tax rules, qualifying turnover (as defined), includes 50% of all receipts of a capital nature – **False** p187 Qualifying turnover is defined in par 1 of the 6th Schedule as: Total receipts from carrying on business activities excluding any amount of a capital nature, and excluding any amounts exempt from tax in terms of certain sections - In terms of the turnover tax rules, any amount of a capital nature received from conducting business must be excluded from qualifying turnover.

9. A company that is registered as a micro business in terms of the Sixth Schedule must have its year of assessment ending on 28/29 February – **True - As per the turnover tax rules, a company, close corporation and co-operative is disqualified as a micro business if its year of assessment ends on a date other than the last day of February**

10. The taxable income of a trust for the 2014 year of assessment is R625 000. How much tax must the trust pay? **40% currently R250,000.00**

**Study Unit 4 - Gross Income Definition**

1. Which one of the following statements is correct? A person other than a natural person is a resident of the Republic if it ?.

   Is incorporated, established or formed in the Republic or has its place of effective management in the Republic

   A person other than a natural person (in other words a business entity such as a company or a close corporation) is a resident of the Republic if it is:

   - incorporated, established or formed in the Republic, or
   - has its place of effective management in the Republic

2. Indicate whether the following statement is true or false: Amounts of a capital nature do not form part of gross income
3. **Which one of the following statements is correct? The year of assessment for a company with a financial year-end of 30 June 2014 is ?**
   - 1 July 2013 to 30 June 2013

4. **Indicate whether the following statement is true or false: Dividends are specifically included in gross income**
   - True

5. **Which one of the following taxpayers is not exempt from tax?**
   - Any company that trades in shares

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**Study Unit 5 General and specific deductions**

**Question 1**

Dumela (Pty) Ltd has taxable income of R350 000 for its 31 January 2014 year of assessment, before allowing a deduction for donations in terms of section 18A. Dumela (Pty) Ltd made a donation of R38 000 to a public benefit organisation approved by the Commissioner under section 30 and received a section 18A certificate from it. What is Dumela’s taxable income amount (after taking the donation into account) for the year of assessment?

- **Taxable Income R350 000**
- **Donation Actual R38 000**

**Allowed only 10% Taxable Income of R350 000, thus only R35 000 claimable.**

**Thus taxable Income after donation deduction R315 000**

=R315 000

That is correct! 😊 In terms of s18A, a deduction for donation to a PBO is limited to 10% of taxable income. In this example, the deduction is R38 000 limited to R35 000 (10%*R350 000). The taxable income of Dumela after taking the s18A deduction into account is therefore R315 000 (R350 000 - R35 000)

**Question 2**

Minnie and Daisy (Pty) Ltd is a well known toy store in South Africa. The company concluded the following transactions with its 90 employees during the financial year ended 31 March 2014. Salaries paid to employees were R16 000 000. Its contributions to provident and medical aid funds on behalf of its employees were R1 200 000. What is the deduction that Minnie and Daisy (Pty) Ltd can claim in respect of the salaries and contributions to provident and medical aid funds in arriving at taxable income?

=R17 200 000

Well done, that is correct. 😊 Section 11(l) provides for the deduction of any sum contributed by an employer during the year of assessment for the benefit of his employees to any pension, provident or medical fund. The deduction is however subject to certain conditions - refer to your textbooks for these conditions

**Question 3**
Mundoball Ltd has a provision for doubtful debts of R1 420 000. It has written off bad debts of R432 000 for the current year. What is the amount SARS will allow as deduction for the provision for doubtful debts in the current year of assessment?

=R355 000

The answer is R355 000 (R1 420 000*25%). Remember the Commissioner grants an allowance of 25% of the total doubtful debts.

Question 4

On 28 February 2014, Moukki Furniture (Pty) Ltd paid an amount of R120 000 for its elevator maintenance contract for the next 12 months from 1 March 2014 to 28 February 2015. Moukki (Pty) Ltd has a 31 March 2014 year end. What is the prepaid amount in respect of the maintenance contract for the 2014 year-end?

=R110 000

Well done, that is correct. The answer is R110 000 (R120 000*(11/12)). The 2014 year of assessment ends on 31 March 2014. The maintenance contract commenced on 1 March 2014 meaning at the end of the 2014 year of assessment, services for March were received and an expense incurred. The remaining 11 months (1 April 2014 to 28 February 2015) fall into the 2015 year of assessment.

Question 5

Assume the same details relating to Moukki (Pty) Ltd as the above question. What amount may be deducted in respect of the maintenance contract, by Moukki (Pty) Ltd to arrive at taxable income for the year of assessment 31 March 2014?

=R10 000

Well done, that is correct. The answer is indeed R10 000 (R120 000*(1/12)). Remember that the 2014 year of assessment ends on 31 March 2014. The maintenance contract commenced on 1 March 2014 meaning at the end of the 2014 year of assessment, services for March were received and an expense incurred. No amount for the prepayment can be claimed in the 2014 year of assessment, as the prepayment is more than 6 months (11 months) and more than R100 000 (R110 000).

Question 6

Assume the same details relating to Moukki (Pty) Ltd as the above question, except that Moukki (Pty) Ltd has a 31 July 2014 year end. What is the prepaid amount in respect of the maintenance contract?

=R70 000

That is correct! The answer is indeed R70 000 (R120 000 x 7/12). The 2014 year of assessment ends on 31 July 2014. The maintenance contract commenced on 1 March 2014, meaning at the end of the 2014 year of assessment, services for 5 months (March 2013 to July 2014) were received and an expense incurred. The remaining 7 months (from August 2014 to February 2015) will be prepaid.

Question 7

Assume the same details relating to Moukki (Pty) Ltd as the above question, (i.e. a 31 July 2013 year end) and Moukki (Pty) Ltd has no other prepaid expenses. What amount may be deducted in respect of the maintenance contract, by Moukki (Pty) Ltd to arrive at taxable income for the year of assessment 31 July 2013?

=R120 000

The correct answer is R120 000 (R50 000 (actually incurred in the current year per s11(a)) + R70 000 (prepayment deductible according to rules per s23H)). The maintenance contract commenced on 1 March 2013, so at the end of the 2013 year of assessment (31 July 2013), services for 5 months were received and an expense of R50 000 incurred. The prepaid expense can also be deducted, as the prepayment is for
less than R100 000 (R70 000), although it is for more than 6 months (7 months) )(remember only one of the requirements need to be met for the prepayment to be deducted).

**Question 8**

In terms of the general deduction formula, specifically section 11(a) of the Income Tax Act, which parts of the below section 11(a) are incorrect? “...there shall be allowed as deductions from the income of such person so derived- • expenditure and losses, • actually paid, • in the production of income, • provided such expenditure and losses are of a capital nature.”

- Actually paid; provided such expenditure and losses are of a capital nature.

Well done, that is correct. The general deduction formula per s11(a) allows a deduction for expenditure and losses actually incurred in the year of assessment in the production of income that is NOT of a capital nature.

**Question 9**

In terms of the general deduction formula, specifically section 11(a) of the Income Tax Act, what is meant when an expense has been “actually incurred”?

- the expense is an unconditional expense

The term "actually incurred" means the expense is an unconditional expense.

**Question 10**

In terms of the general deduction formula, certain tests may be applied to determine whether the expenditure is “not of a capital nature”.

The courts have established certain tests or norms which are of assistance in determining the capital or revenue nature of certain item or class of expenditure. Determining whether an asset or advantage is a once off or recurring expense is one such test.

**Question 11**

In terms of the general deduction formula, it’s required that a trade be carried on by the taxpayer. Which of the following is not included in the “trade” definition?

- Hobby

Well done, that is correct. A hobby is not a trade is defined in s1 of the Act. A trade as defined in s1 of the Act includes: "every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent...or any design...or any trademark...or any copyright...or any other property which is of a similar nature”

**Question 12**

If R65 000 is incurred to purchase a patent, which one of the following amounts would be deducted as an allowance in determining taxable income in a particular year of assessment?

=R3 250

A deduction of 5% of the expenditure (that exceeds R5 000) is allowed for patents developed after 1/1/2004. Therefore the deduction allowed in the example above will be R3 250 (R65 000*5%)

**Question 13**
Which of the following expenses may not be deducted? Expenses relating to:

- fines and corrupt activities

Well done, that is correct! The Act prohibits the deduction of expenditure relating to fines and corrupt activities

**Question 14**

Included in a taxpayers list of bad debts, is an amount of R10 000 that was borrowed to an employee who has absconded (left without paying it back). What will be allowed as a deduction with regards to the R10 000 bad debt in terms of section 11(i)?

= RNil

Remember section 11(i) allows the deduction of bad debts provided the amount was included in the taxpayer’s income in either current or any previous year of assessment. The R10 000 granted to an employee is a loan and would therefore not have been included in the taxpayer’s income at any point

**Study Unit 6 CAPITAL ALLOWANCES**

**Question 1**

A capital allowance is an allowable deduction for income tax purposes

- True

A taxpayer may claim capital allowances on capital assets used involving the write-off of the cost of a capital asset over a period of time

**Question 2**

A section 11(e) allowance may be claimed with regard to which of the following assets?

- Moveable assets in general such as motor vehicles

A section 11(e) allowance is only applicable to moveable assets such as computers, motor vehicles and office equipment, not being structures and works of a permanent nature

**Question 3**

The cost of repairs to a capital asset is added to the cost of such capital asset.

- False

Only improvements made to a capital assets will be added to the cost of such asset.

**Question 4**

The maximum section 11(e) allowance claimable by a taxpayer on a computer purchased for R12 000 (excluding VAT) on 1 June 2013 and brought into use on 1 July 2013, if the year of assessment ends on the last day of February 2014 and the maximum write-off period is three years, will be ...

= R4 000
R4 000 was calculated as follows: R12 000/3 = R4 000. Section 11(e) requires apportionment from the date the asset was brought into use (1/7/2013) until the end of the year of assessment. In option B, the incorrect apportionment was applied (R12 000/3 x 9/12 = R3 000). The asset was only brought into use on 1/7/2013. The correct answer is R2 667, calculated as follows: R12 000/3 x 8/12 = R2 667

**Question 5**

A section 12C allowance may be claimed on any plant or machinery used in the process of manufacturing or a similar process regardless of whether or not it is being brought into use for the first time

- False

For a section 12C allowance to apply, the manufacturing asset has to be brought into use for the first time. It does not matter if the asset is new or used.

**Question 6**

The maximum section 12C allowance that may be claimed by a taxpayer on new manufacturing equipment purchased for R150 000 (excluding VAT) on 1 May 2013 and brought into use on 1 June 2013 and incurring moving and installation costs of R12 000 (excluding VAT), if the year of assessment ends on the last day of February 2014, will be...

=R64 800 calculated it as follows: R150 000 x 40% (new) = R60 000. The moving and installation cost should have been added to the cost of the manufacturing equipment and the section 12C allowance calculated on R162 000. In option C, you calculated it as follows: R150 000 x 40% x 9/12 = R45 000. Please note that the installation costs should be added to the cost price and there is no apportionment of the section 12C allowance where an asset was not used for the full tax year. In option D, you calculated it as follows: R150 000 + R12 000 = R162 000 x 40% x 9/12 = R48 600. Please note that there is no apportionment of the section 12C allowance where an asset was not used for the full tax year. The correct answer is: (R150 000 + R12 000) = R162 000 x 40% = R64 800

**Question 7**

A small business corporation (as defined) may claim a section 12E allowance on (both new and used) manufacturing assets of 100% and a 50% allowance on non-manufacturing assets (for the first year only) brought into use during the year of assessment.

- True

The section 12E allowance may be claimed on both new and used assets. Manufacturing assets qualify for a 100% deduction in the first year and non-manufacturing assets for a 50% allowance in the first year.

**Question 8**

A taxpayer may claim an allowance in terms of section 13(1) on a manufacturing building used partly for carrying on the process of manufacturing

- False

A section 13(1) allowance for a manufacturing building can be claimed if it is used wholly or mainly for carrying on the process of manufacturing.

**Question 9**

A taxpayer may claim an allowance in terms of section 13quin (commercial building allowance) regarding new or unused commercial buildings owned by the taxpayer and used wholly or mainly for the purposes of producing income in the course of the taxpayer’s trade.
A taxpayer may claim a section 13quin commercial building allowance on new or unused commercial buildings owned by the taxpayer and used wholly or mainly for the purpose of producing income in the course of the taxpayer’s trade.

**Question 10**
A taxpayer sold computer equipment on 30 November 2013 for R10 000 when it had a tax value of R12 000. The original cost price was R18 000. The allowance the taxpayer may claim for the tax year ended 28 February 2014 will be...

=R 2000 scrappin

In option A, the proceeds on disposal (R10 000) was less than the tax value (R12 000) and therefore a scrapping allowance of R2 000 can be claimed for the 2014 year of assessment. In option C, you calculated the R8 000 as follows: Proceeds less original cost (R10 000 - R18 000) = R8 000, and disregarded the R6 000 tax allowances previously granted (R18 000 less R12 000). The correct answer is: Proceeds less tax value = R10 000 - R12 000 = R2 000 scrapping allowance.

"SU 7 - Capital gains tax " for TAX2601-14-S1

**Question 1**
A South African resident is taxed on a capital gain made on the disposal of movable property situated in Mauritius. Is this statement true or false?

- **TRUE**

That's correct. A South African resident is taxed on capital gains made on the sale or disposal of assets which he owns anywhere in the world.

**Question 2**
Which one of the following is not an asset for capital gains tax purposes?

- Trading stock

That's correct. A South African resident is taxed on capital gains made on the sale or disposal of assets which he owns anywhere in the world.

**Question 3**
Which one is not a disposal for capital gains tax purposes?

- Improvement of an asset

**Question 4**
Which one of the following is a disposal for capital gains tax purposes?

- THE DISTRIBUTION OF AN ASSET BY A COMPANY TO A SHAREHOLDER – REFER P148 OF THE TEXTBOOK

**Question 5**
A business entity may not use the annual exclusion.

**Question 6**
Which one of the following formulas is the correct one for calculating a recoupment on the disposal of an asset?
Question 7
Which one of the following costs is not allowed as part of the base cost (as per para 20 of the eighth schedule

- Borrowing costs

BORROWING COSTS / INTEREST WOULD HAVE BEEN DEDUCTED FROM INCOME TAX. IF AN EXPENSE IS ALLOWABLE AS A DEDUCTION IN DETERMINING TAXABLE INCOME, IT CANNOT FORM PART OF THE BASE COST

Question 8
Which one of the following formulas is the correct one for calculating the base cost for an asset purchased before 1 October 2001?

- Valuation date value plus costs after 1 October 2001

Question 9
Which one of the following is the formula for the 20% rule, which is used in determining the valuation date value of an asset?

- 20% (proceeds less costs after 1 October 2001)

Question 10
X (Pty) Ltd sold several assets during the 2014 year of assessment. The aggregate capital gain for 2014 was calculated correctly as R815 000. The company has an assessed capital loss brought forward from 2013 of R200 000. What is the taxable capital gain of X (Pty) Ltd?

- \( R409\,590 \) \( = \) \( (R815\,000 - R200\,000) \times 66.6\% \)

TAX2601 ASSIGNMENT 1 FOR 2014/01

QUESTION 1
Which of the following is a tax not provided for by the South African government?
(1) estate duty
(2) income tax
(3) Value-added tax
(4) wealth tax

QUESTION 2
The South African tax regime is set by …
(1) SARS.
(2) the Commissioner.
(3) National Treasury.
(4) the Minister of Finance.
QUESTION 3
A residence basis of taxation means that persons who are…
(1) residents are subject to tax on their worldwide income.
(2) non-residents are subject to tax on their foreign income only.
(3) residents are subject to tax on their South African income only.
(4) non-residents are subject to tax on their worldwide income.

QUESTION 4
Taxes in South Africa are classified according to a number of factors. One of the factors is based on the method used to calculate tax.
Which one of the following is not a method used to calculate tax in South Africa?
(1) proportional tax
(2) regressive tax
(3) indirect tax
(4) progressive tax

QUESTION 5
A natural person is taxed according to the … method.
(1) regressive tax
(2) proportional tax
(3) progressive tax
(4) indirect tax

QUESTION 6
With regard to interpretation notes, which one of the following statements is correct?
(1) They are not merely the opinion of SARS, but considered law.
(2) They set out how SARS will interpret or apply provisions.
(3) They are generally binding on SARS and on taxpayers.
(4) They form part of the Income Tax Act.

QUESTION 7
The contra fiscum rule will be applied where a provision of the Income Tax Act …
(1) is unclear.
(2) has no interpretations.
(3) has two interpretations.
(4) is unfair.

QUESTION 8
If a taxpayer would like to appeal SARS on a particular tax matter, after an unsuccessful ADR process and the amount in question is more than R500 000, the case can then be taken to the…
(1) tax board.
(2) tax court.
(3) Supreme Court of Appeal.
(4) Constitutional Court.

QUESTION 9
The highest court in South Africa that has the final ruling on all matters, except those that are constitutional issues, is the …
(1) Supreme Court of Appeal.
(2) Highest Court.
(3) Constitutional Court.
(4) Supreme Court.

QUESTION 10
Based on how the court case is referred to, in which court was the case New State Areas Ltd v Commissioner for Inland Revenue 1946 AD 610 at 627 ruled?
(1) Supreme Court of Appeal
(2) tax court
QUESTION 11
Taxable income is calculated for a year. For companies the tax year runs …
(1) from 1 January to 31 December.
(2) from 1 March to 28/29 February.
(3) for the same period as the financial year.
(4) for the same period as the calendar year.

QUESTION 12
The basic framework for calculating taxable income is …
(1) income, minus allowances and deductions, minus taxable capital gain.
(2) income, minus deductions and allowances.
(3) income, plus deductions and allowances, plus taxable capital gain.
(4) income, minus deductions and allowances, plus taxable capital gains.

QUESTION 13
Which one of the following statements is true?
(1) SARS will refund a taxpayer, where prepaid taxes are in excess of the net normal tax calculated for a tax year.
(2) SARS will refund a taxpayer, where the net normal tax calculated for a tax year is in excess of the prepaid taxes.
(3) The taxpayer will owe SARS a tax amount, if the prepaid taxes were in excess of the net normal tax calculated for a tax year.
(4) The taxpayer will owe SARS a tax amount, if the net normal tax calculated for a tax year is less than the prepaid taxes.

QUESTION 14
Where a taxpayer disagrees with an assessment received from SARS, what is the first step the taxpayer must take?
(1) Lodge an ADR form 2 with SARS.
(2) Lodge an appeal with the tax board.
(3) Lodge an objection on an ADR1 form with SARS.
(4) Lodge an appeal with the tax court.

QUESTION 15
Which one of the following arrangements may constitute a reportable arrangement?
(1) An arrangement where there is no „tax benefit“.
(2) An arrangement where the tax benefit exceeds R1 million.
(3) An arrangement listed under section 36 of the Tax Administration Act.
(4) Options (1) and (3)

QUESTION 16
When a taxpayer bears the burden of proof, it means…
(1) SARS has to show that an assessment is incorrect.
(2) the taxpayer has to show the assessment is correct.
(3) SARS has to show an assessment is correct.
(4) the taxpayer has to show the assessment is incorrect.

QUESTION 17
For how long must a taxpayer keep records with regard to tax returns?
(1) Three years
(2) Five years
(3) One year
(4) No records need to be kept after filing a return

QUESTION 18
Which one of the following statements is correct with respect to refunds due to taxpayers?
(1) SARS may only make a refund to a taxpayer after such a refund has been audited.
(2) The refund has to be claimed within three years of a self-assessment.
(3) The refund has to be claimed within five years of a SARS assessment.
(4) SARS may set-off refunds on a taxpayer’s income tax against other outstanding taxes owing.

QUESTION 19
If a taxpayer has objected following the prescribed manner, how many days does the Commissioner have in which to reply to the taxpayer regarding the objection, assuming it is a simple matter in dispute and no further information was requested?
(1) 60 days
(2) 45 days
(3) 30 days
(4) 90 days

QUESTION 20
With regard to the objection procedure a taxpayer must follow, when can a notice of appeal be made by a taxpayer?
(1) after reasons of a particular assessment have been provided by SARS to the taxpayer
(2) after the due date per the assessment
(3) after the matter has gone to the Tax Court
(4) after an objection has been disallowed by SARS

QUESTION 21
A close corporation is taxed at what tax rate?
(1) 28%
(2) 40%
(3) using a sliding scale
(4) using a tax table

QUESTION 22
RentaToy Close Corporation (“CC”) would like to know if they qualify as a small business corporation. You are provided with the following information:
- The gross income for the 2013 (their first year of trade) was R1,7 million.
- Sophia and Zara (two sisters) and Toyland (Pty) Ltd are the only shareholders of the CC.
- Zara owns 5 000 shares in a company listed on the Johannesburg Stock Exchange.
- The CC has no investment income.

On what grounds doesn’t RentaToy CC qualify as a small business corporation?
(1) It has no investment income
(2) Zara owns shares in a listed company
(3) RentaToy is a CC
(4) Toyland (Pty) Ltd is a shareholder

QUESTION 23
Litchi Café (Pty) Ltd qualifies as a small business corporation. For the 2014 year of assessment ending 28 February, it had turnover of R1 925 000 and taxable income of R525 000. How much tax will it have to pay?
(1) R20 852
(2) R147 000
(3) R110 250
(4) R54 452 = (R20 852 + ((R525 000 - R365 000) x 21%))

QUESTION 24
PoohBear Creche (Pty) Ltd calculated its taxable income for the 31 March 2014 tax year to be R1 400 000. The basic amount (last assessed for 2013) is R1 700 000. It has made a first provisional tax payment of R238 000. What will the
second provisional tax payment be in respect of the 2014 year and by when must it be paid? (Assume the company is not a small business corporation or a micro business.)

(1) R154 000, payable by 31 March 2014
(2) R392 000, payable by 31 March 2014
(3) R476 000, payable by 28 February 2014
(4) R154 000, payable by 28 February 2014

(R1 400 000 x 28%) - R238 000; second provisional payments are due before or on the same date as the financial year-end of the company.

QUESTION 25
Funky Nails (Pty) Ltd was last assessed in 2011 with a taxable income of R691 000. The taxable income for 2012 and 2013 was R790 000 and R920 000 respectively. The company has a 31 December year-end. Their first provisional tax payment for the 2014 tax year is due on 30 June 2014. What amount must they use to base their first provisional tax payment on?

(1) R691 000
(2) R920 000
(3) R746 280
(4) R856 840

Last assessment was 2011, therefore the taxable income for 2011 of R691 000 must be increased by 8% for each year that has passed until the tax year in question, which is 3 years. Therefore, the basic amount is = R691 000 + (R691 000 x 8% x 3yrs) = R856 840.

QUESTION 26
A close corporation has taxable income for the 2014 tax year of R375 000. It has made first and second provisional tax payments of R53 000 and R10 000 respectively for the 2014 tax year. Assume the company is not a small business corporation or a micro business. What is the company’s final tax liability for the 2014 tax year?

(1) R105 000
(2) R42 000 = (R375 000 x 28%) - R53 000 – R10 000)
(3) R63 000
(4) Rnil

QUESTION 27
Mrs Fitness Freak has recently started a small business that sells only organic vitamins and supplements. She received only cash amounts of R632 000 for the period 1 September 2013 to 28 February 2014. This is the first year of trade. Mrs Fitness Freak would like to know if she would qualify as a micro business. Which one of the following statements is correct regarding Mrs Fitness Freak’s status with regards to qualifying as a micro business?

(1) She qualifies as a micro business as the receipts of R632 000 are less than the R1 million turnover limit.
(2) She does not qualify as a micro business, as the receipts of R632 000 are not more than the R1 million turnover limit.
(3) She qualifies as a micro business as the receipts of R632 000 are more than the R500 000 proportional turnover limit.
(4) She does not qualify as a micro business as the receipts of R632 000 are more than the R500 000 proportional turnover limit.

QUESTION 28
Kids Party Co CC qualifies as a micro business. They received cash amounts of R650 000 relating to party services for the period 1 March 2013 to 28 February 2014. Excluded from this amount is R42 000 received in cash from the sale of a delivery vehicle as well as some rental income of R21 000 which the CC received from occasionally renting out the garden portion at the front of their business premises for private functions. What is Kids Party Co CC’s taxable turnover for the year ended 28 February 2014?

(1) R650 000
(2) R713 000
(3) R692 000 = (R650 000 + (R42 000 x 50%) + R21 000)
(4) R671 000
QUESTION 29
A company that is registered as a micro business for taxation purposes must pay tax for the February 2014 year of assessment. The company’s accountant provides you with the following figures:
Qualifying turnover limit: R1 million
Qualifying turnover: R589 000
Taxable income: R261 000
Taxable turnover: R633 000
What is the tax liability of the company for the 2014 year of assessment?
(1) R73 080
(2) R9 060
(3) \( R10 820 = (R5 500 + (R633 000 - R500 000) \times 4\%) \)
(4) R5 500

QUESTION 30
A company (not a small business corporation as defined) must make its first provisional tax payment on 31 March 2014 for the year of assessment ending 30 September 2014. The latest assessment received was in respect of the 2013 year of assessment (received on 26 February 2014) and reflected a taxable income of R1.4 million. The 2012 tax assessment reflected taxable income of R967 000.
What is the first provisional tax amount that must be paid by the company on 31 March 2014?
(1) R135 380
(2) \( R157 041 \)
(3) R392 000
(4) R270 760

The 2013 taxable income is used, as the assessment was received more than 14 days before the provisional payment is due. This amount will not be increased with 8% per year, as not more than 18 months have passed. \( (R1 121 721 \times 28\%) / 2 = R157 041. \)

Study guide 1
In SA taxpayers are taxed on the residence basis of taxation, meaning all persons who are residents are subject to taxation in terms of the Income Tax Act in respect of ALL income earned anywhere in the world.

Where a person is not a resident in SA, they will still be taxed in SA on income earned from a SA source.

Figure 2: Classification of taxes in South Africa

<table>
<thead>
<tr>
<th>What taxes are levied on</th>
<th>Method used to calculate tax</th>
<th>Who must pay the tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>Proportional tax</td>
<td>Direct tax</td>
</tr>
<tr>
<td>These are taxes that are levied on income which is earned Eg income tax</td>
<td>Tax that is levied at a fixed rate Eg companies tax</td>
<td>The same person who earns the income pays the tax Eg income tax and capital gains tax</td>
</tr>
<tr>
<td>Consumption</td>
<td>Progressive tax</td>
<td>Indirect tax</td>
</tr>
<tr>
<td>These are taxes that are levied on the sale or use of commodities. These taxes take the form of price increases and are paid by the person purchasing or using the commodity. Eg VAT, excise duty, customs duty</td>
<td>The tax rate increases with the amount of income earned Eg income tax on natural persons</td>
<td>The seller bears the impact of the tax while the consumer pays the tax Eg VAT</td>
</tr>
<tr>
<td>Wealth</td>
<td>Regressive tax</td>
<td></td>
</tr>
<tr>
<td>These are taxes that are levied on the transfer of property Eg capital gains tax, estate duty, donations tax</td>
<td>The tax rate decreases with the amount of income earned Eg no such tax in South Africa</td>
<td></td>
</tr>
</tbody>
</table>
These are taxes that are levied on specific transactions. Eg transfer duty, marketable securities tax, fuel levy, dividend tax.

The purpose of the interpretation notes is, thus, to set out how SARS will interpret or apply certain provisions. A court of law may also not agree with an interpretation note.

Where a term is defined in both the Income Tax Act and the Interpretation Act, the definition found in the Income Tax Act will take precedence over the definition in the Interpretation Act.

When interpreting the wording used in the Income Tax Act:

- You should apply the literal meaning first – words should be limited to their simplest, ordinary, most obvious meaning (“clear and unambiguous”). If this meaning is clear then it must be applied even if it gives rise to unfair results.
- Take note of the real intention of the legislator – when a provision is introduced to the Income Tax Act for the first time it is usually discussed in an explanatory memorandum. This explanation will generally give the intention of introducing the provision, which, in turn, will indicate the intention of the legislator. The purpose behind the words must after all be determined. Often words do not reflect the true intention of the person. The contextualization-of-the-text approach to statutory interpretation (“text-in-context” or the purposive approach) has been confirmed by the Constitution of South Africa (s 39(2)).
- Apply the contra fiscum rule. This rule provides that where a provision of the Income Tax Act has two interpretations, the court will interpret the provision in terms of the interpretation that places the smaller burden on the taxpayer.
Step 1:
- **Alternative dispute resolution (ADR)**

SARS and the taxpayer may use this process to settle any type of dispute that relates to a dispute on interpretation of facts. To settle does not mean that the taxpayer or SARS has to accept one or the other’s interpretation; it just means that both parties must agree to the tax in question.
Step 2:
- The Tax Board
Any taxpayer who disagrees with SARS on any decision of the commissioner has to first appeal to the Tax Board, provided that the
- amount in question is less than R500 000 (this can be changed by the Minister of Finance) or
- the commissioner and the taxpayer mutually agree to make use of the tax board or
- the taxpayer or the commissioner does not object to the tax board making a ruling

Step 3:
- The Tax Court (previously the Special Court for Hearing Income Tax Appeals)
Where an ADR process was unsuccessful in resolving a disagreement, or where the Tax Board has referred an appeal, the Tax Court is next in line to try to solve the disagreement between SARS and the taxpayer. The Tax Court is a creature of statute, meaning it has no inherent powers such as the High Court. Although the Tax Court is not a court of law, its rulings have persuasive value to the parties concerned.

Step 4:
- High Court (previously called the Supreme Court)
The High Court listens to any case that is too serious for the Tax Board, or the Tax Court or where a case is being appealed (i.e. where a taxpayer or SARS wants to change a decision)

Step 5:
- Supreme Court of Appeal (previously called the Appellate Division)
This is the highest court (except for the Constitutional Court) and has the final say on all matters, except those that are constitutional issues. This court only hears cases that are on appeal from lower courts.

Step 6:
- Constitutional Court
The Constitutional Court is the highest court in South Africa and deals with issues of a constitutional nature. A taxpayer will appeal or challenge a decision by the commissioner in the Constitutional Court in the event a dispute concerns the constitutionality of legislation. There is no appeal against the decision of the Constitutional Court.

The abbreviations for the courts are as follows:
(ITC)/(SATC) Tax Court
(HC) High Court
(SCA) Supreme Court of Appeal of South Africa
(CC) Constitutional Court

<table>
<thead>
<tr>
<th>Table 1: Basic framework for calculating taxable income</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>XXX</td>
</tr>
<tr>
<td>Less: Deductions and allowances</td>
<td>(XXX)</td>
</tr>
<tr>
<td>Taxable income before capital gains tax</td>
<td>XXX</td>
</tr>
<tr>
<td>Add: Taxable capital gain</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td>XXX</td>
</tr>
</tbody>
</table>
Table 2: Framework for the calculation of tax liability based on taxable income

<table>
<thead>
<tr>
<th>R</th>
<th>XXX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Using taxable income as calculated in table 1, calculate normal tax depending on the type of taxpayer</td>
<td>XXX</td>
</tr>
<tr>
<td>Less: Prepaid taxes</td>
<td>(XXX)</td>
</tr>
<tr>
<td>Tax owing to SARS or (tax refundable by SARS)</td>
<td>XXX</td>
</tr>
</tbody>
</table>

* The government needs money to offer services.
* This money is collected mainly in the form of taxes.
* Taxes take on many forms.
* Income tax is the tax, which collects the most money for the South African government.
* In order to calculate income tax a framework is used.

Where a taxpayer fails to submit a return or submits the return after the due date, SARS may

- issue an estimated assessment
- issue an additional or a reduced assessment
- withdraw an assessment

The objection and appeal procedures for the taxpayer can be summarised as follows:

- Receives assessment from SARS
- Correct
  - Yes: Accepts assessment and pays the assessed tax or receives a refund
  - No: Lodges an objection on an ADR1 form via e-filing with SARS
- Rectify
  - Yes: Accepts new assessment and pays revised assessed tax or receives a refund
  - No: Lodges an appeal

You should know and understand the following about objection and appeal:

- that it is the taxpayer’s responsibility to prove that the assessment is incorrect; in tax terms we say that the burden of proof vests with the taxpayer
that the prescribed objection procedure must be followed

that the prescribed appeal procedures against a disallowed objection must be followed

the alternative dispute resolution (ADR) process

the way in which tax is paid in the case of a pending objection and appeal

A taxpayer can enter into an ADR with SARS at any time. The purpose of this process is to settle tax disputes in a speedier, more cost-effective manner and, as far as possible, out of court. Both parties must agree that the ADR procedures can be followed. However, this process can be stopped at any time and the case referred to the courts. If the option of taking the matter to court is chosen, the matter will generally be taken first to either the tax board or the tax court, depending on the value and merits of the case. Thereafter, the party that loses the case can follow the normal South African legal precedent, firstly going to the Supreme Court and then the High Court, and even in certain cases to the Constitutional Court

QUESTION 2.1 (13 marks, 16 minutes)

Question 1
Discuss how John Majale (Pty) Ltd, a newly registered South African company, will register as a taxpayer for the first time (referring to the formal registration form applicable to companies). Also list what information the company will need to complete the form. Please visit SARS’s website to assist you with this. (5)

1. John Majale (Pty) Ltd has to complete form IT/IB 77C and submit the signed and completed form to any SARS branch office (1). The following information has to be completed on the application for registration:

- Registered name of the company
- Trade name of the company (only if different from registered name)
- Postal address
- Registered address
- Company registration number (issued by CIPC)
- Nature of the business
- Turnover (can be an estimate for first registration)
- Registration date (with CIPC)
- Full banking particulars for the company
- Particulars of the public officer (representative for the company)
- Particulars of the three main directors/shareholders of the company
- Income details such as whether the company will be trading, if the company should also be registered for provisional tax, the estimated taxable income and the financial year end of the company. (4) (max 5)

Question 2
John Majale (Pty) Ltd does not agree with the tax assessment issued by SARS for the current year of assessment. A wear-and-tear allowance of R12 500 claimed as a deduction on the submitted income tax return was disallowed as a deduction in the assessment process. The ITA34 tax assessment issued by SARS reflects an amount of R4 750 due and payable to SARS. Discuss the process that John Majale (Pty) Ltd should follow in order to object to the issued tax assessment. (5)

2. John Majale (Pty) Ltd has to submit an objection to SARS within 30 days from the date of the assessment for the current year (1).
- The objection must be in writing and must specify in detail the grounds upon which the objection is made (1). John Majale (Pty) Ltd could therefore submit a copy of the financial statements for the current year of assessment and a detailed income tax calculation to support the deduction of the wear-and-tear claimed of R12 500 (1).

- The objection must be signed by the taxpayer. Therefore, the public officer of the company should sign the objection (1).

- The objection must be submitted using an ADR 1 form (1).

**Total (5)**

**Question 3**

SARS has declined the objection lodged by John Majale (Pty) Ltd to the tax assessment issued by SARS. Discuss what procedure, if any, John Majale (Pty) Ltd can follow to rectify the incorrect tax assessment.

John Majale (Pty) Ltd will have to pay the outstanding amount of R4 750 to SARS (1) and then proceed to lodge an appeal.

- John Majale (Pty) Ltd will have to appeal within 30 days of the notice of disallowing the objection (1).
- An ADR 2 form is used for the notice of appeal, which must contain the details of the tax in dispute, i.e. the disallowance of the wear & tear deduction and the grounds of appeal (1). (3)

<table>
<thead>
<tr>
<th>Mr Jones’s tax liability</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>840 000</td>
</tr>
<tr>
<td>Tax per tax tables (((R840 000 – R638 000) x 40%) + R185 205))</td>
<td>266 005</td>
</tr>
<tr>
<td>Less: primary rebate:</td>
<td>(12 080)</td>
</tr>
<tr>
<td><strong>Mr Jones’s tax liability</strong></td>
<td><strong>253 925</strong></td>
</tr>
</tbody>
</table>

There are two major tax benefits of being an SBC:

1. The tax rate for an SBC is considerably lower than that of a normal company. While most other companies pay tax at a rate of 28% on their taxable income, an SBC will pay tax according to a sliding scale.

2. The immediate write-off of all plant or machinery used in a manufacturing process or similar process in the year of assessment in which it is brought into use for the first time. Furthermore, an accelerated write-off allowance for depreciable assets (other than manufacturing assets) acquired on or after 1 April 2005 is available at 50% of the cost of that asset in the tax year during which that asset was brought into use for the first time, 30% in the second year and 20% in the third year.

For taxation purposes, a close corporation is considered to be a company. 28%

For tax purposes, a micro business is a special type of enterprise. Micro businesses can be companies or sole traders (individuals). A new simplified tax system, called turnover tax, was introduced on 1 March 2009 and is available to all businesses that qualify as “micro businesses”. This simplified tax system provides for a single tax, called turnover tax, which is a substitute for income tax, capital gains tax, value-added tax and dividend tax (partially). The system was introduced mainly to reduce the tax compliance burden of small businesses. A micro business pays tax on its taxable turnover at very low tax rates according to a specific table.

first step is determining the qualifying turnover of the entity (method to determine whether a person/entity qualifies as a micro business)
next step is to calculate the **taxable turnover**. The taxable turnover is the taxable amount to which the rates in the specific table (refer 8.2) are applied.

Only 50% of the capital receipts, proceeds from the sold equipment used **mainly** for business purposes, was added to the business turnover to get to the taxable turnover. Capital receipts obtained from the sale of the primary residence were not added to the turnover, as they were not used mainly for business purposes, and are thus subject to capital gains tax.
Summary of the persons who are disqualified from registering micro businesses

- Trusts
- Partnerships with turnover > R1m p/a
- Natural persons >20% income from providing professional services
- Natural person providing personal services
- Company or Close Corporation with investment income >20% of it’s income

Micro businesses do not pay tax according to the provisional tax collection method. They are, however, subject to interim payments, and pay tax twice a year.

In a Micro Business running costs and repairs are not taken into account. This is because tax is only paid on taxable turnover.

In a Close Corporation it would then be taxed as a CC at 28%. Then taxable income would need to be calculated taking the expenses into account.

Example 2 deals with an individual taxpayer. You will see that all of Mr S”s income received, other than the turnover of the micro business, is taxed normally (using the tax table for individuals) and then the rebate is applied. His micro business turnover is taxed separately according to the rates applicable to a micro business. The two tax amounts are then added together as the total tax that Mr S owes.

A trust is taxed at a flat rate of 40%. The income distributed by a trust to a beneficiary (if the beneficiary is an individual) will be taxed as taxable income of the beneficiary using the tax tables; thereafter the rebates are deducted.

Farmers who are sole proprietors can elect to be taxed according to the tax tables or in terms of a special averaging tax calculation. In terms of their farming income farmers are provisional tax-payers.

Provisional tax is not another tax but rather a method of collecting taxes.

Additional tax
SARS may levy additional tax of up to 200% of the provisional tax payable if the taxpayer:
- does not submit the income tax return on time;
- does not disclose all his/her income on the income tax return; and/or
- makes a false statement or declaration on the income tax return.

SARS may also levy additional tax amounting to 20% of the provisional tax payable if the estimate used for the second provisional tax payment is less than the “safe haven” amount. This safe haven amount varies depending on the provisional taxpayer’s taxable income.

Safe haven for taxpayers with taxable income of R1 million or less

Should the taxpayer”s taxable income for the current year of assessment be less than R1 million, the 20% additional tax will NOT be payable if the estimated taxable income used for the second provisional payment is equal to the lower of:
- the basic amount; or
- 90% of the actual taxable income for the year of assessment.

Should the estimate used be lower than this amount, SARS will levy an automatic penalty of 20% additional tax on the shortfall. The taxpayer may approach SARS for a full or partial reduction of the penalty if the estimate was seriously calculated and not deliberately or negligently understated.

Safe haven for taxpayers with taxable income of more than R1 million

Should the taxpayer”s taxable income for the current year of assessment be more than R1 million, the 20% additional tax will NOT be payable if the estimated taxable income used for the second provisional payment is at least equal to 80% of the actual taxable income for the year of assessment.
Should the estimate used be lower than this amount, SARS may impose the 20% additional tax on the shortfall if it is not satisfied that the estimate was seriously calculated or not deliberately or negligently understated. Therefore, this additional tax is discretionary.

**Interest**
SARS may charge interest at the prescribed rate if:
- provisional tax paid in respect of a year of assessment is not sufficient to offset the taxpayer’s assessed final income tax liability in full; and/or
- provisional tax is not paid on time.

The Minister of Finance determines this prescribed rate of interest from time to time.

**Penalties**
SARS may charge penalties in addition to interest. SARS regards failure by a provisional taxpayer to submit an estimate (on an IRP6 certificate) of taxable income, as and when required under the Act, as a criminal offence, liable on conviction to a fine or imprisonment of 24 months.

In addition to the fixed-amount penalty, the taxpayer also has to pay a penalty equal to 10% of the amount of provisional tax that a provisional taxpayer fails to pay, as and when required under the Act.

- In order to calculate taxable income, a tax framework is used irrespective of the type of taxpayer/business entity.
- Different taxpayers pay different rates of tax.
- Specific requirements must be met before certain business entities will qualify as a small business corporation or a micro business.
- Certain taxpayers must register as provisional taxpayers and must make provisional tax payments.
- If provisional taxpayers fail to submit or underestimate their payments, penalties, additional tax and interest will be levied by SARS.

The following diagram summarises the classification and income tax rate for companies (remember, in the examination you must be able to identify the type of company that is being discussed):
QUESTION 3.1 (21 marks, 25 minutes)

Miriam Dube and her mother are the only shareholders of Organic Foods (Pty) Ltd. The company was incorporated in February 2013 and started trading on 1 April 2013. Miriam and her mother do not have any kind of other shareholding. The only income they have is from selling organic vegetables at food markets on weekends, which they grow on a small plot that they own. They only accept cash from customers, which amounted to R540 000 for the year of assessment ending 31 January 2014. A friend of the family is an accountant and performed some tax calculations for the company. Below are some of the calculated amounts (as at 31 January 2014) pertaining to the year of assessment:

<table>
<thead>
<tr>
<th>Amount</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>320 000</td>
</tr>
<tr>
<td>Qualifying turnover</td>
<td>540 000</td>
</tr>
<tr>
<td>Taxable turnover</td>
<td>580 000</td>
</tr>
<tr>
<td>Cash/revenue receipts</td>
<td>540 000</td>
</tr>
<tr>
<td>Capital receipt from the sale of equipment</td>
<td>80 000</td>
</tr>
<tr>
<td>First provisional tax payment</td>
<td>nil</td>
</tr>
</tbody>
</table>

REQUIRED:

(a) Determine whether or not Organic Foods (Pty) Ltd will qualify as a small business corporation or a micro business. List the requirements one has to consider and which are applicable to the facts provided. (12)

<table>
<thead>
<tr>
<th>Requirements</th>
<th>a SBC?</th>
<th>a Micro Business?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders - natural persons</td>
<td>All shareholders are natural persons (1)</td>
<td>All shareholders are natural persons (1)</td>
</tr>
<tr>
<td>Shareholders don't hold shares</td>
<td>Shareholders don't hold shares in other companies, CC or Co-operatives (1)</td>
<td>Shareholders don't hold shares in other companies, CC or Co-operatives (1)</td>
</tr>
<tr>
<td>Gross income or Qualifying turnover</td>
<td>Gross income is less than R20 million (1)</td>
<td>Qualifying turnover less than R1 million (1)</td>
</tr>
<tr>
<td>Investment income</td>
<td>None (1)</td>
<td>None (1)</td>
</tr>
<tr>
<td>Private company</td>
<td>Yes (1)</td>
<td>Yes (1)</td>
</tr>
<tr>
<td>Receipts</td>
<td>Not a requirement</td>
<td>Received a capital receipt of less than R1.5 million (namely R80 000) (1)</td>
</tr>
<tr>
<td>Year end</td>
<td>Not a requirement</td>
<td>Year-end is 31 January and not the last day of February (1)</td>
</tr>
</tbody>
</table>
(b) Assume Organic Foods (Pty) Ltd qualifies as a small business corporation. Calculate the tax liability for the year of assessment ending 31 January 2014.

R
Taxable income 320 000 (1)
Taxable income is between R67 111 and R350 000, therefore:
Tax liability is 7% of the amount over R67 111
= (R320 000 – R67 111) x 7% 17 702 (1)

(c) Assume Organic Foods (Pty) Ltd qualifies as a micro business. Calculate the tax liability for the year of assessment ending 31 January 2014.

R
Taxable turnover 580 000 (1)
Taxable turnover is between R500 000 and R750 000, therefore:
Tax liability is R5 500 + 4% of the amount above R500 000
= R5 500 + (4% x (R580 000 – R500 000)) 8 700 (1)

(d) Assume Organic Foods (Pty) Ltd did not qualify as a small business corporation or micro business. How will Organic Foods (Pty) Ltd be taxed? Calculate the second provisional tax payment that must be made by Organic Foods (Pty) Ltd and by what date must it be paid? (12)

Organic foods (Pty) Ltd will be taxed as a company at a tax rate of 28% (1)
The second provisional tax payment that will need to be made is:
Taxable income (note below) 320 000 (1)
Tax liability for the year (rate of 28%) 89 600 (1)
Amount payable is 89 600
Less: first provisional tax payment (nil) (1)
Amount due/payable 89 600

The amount is payable on 31 January 2014.

Note:
When calculating the second provisional tax payment, if the taxpayer has taxable income of less than R1 million, then the taxpayer can use the basic amount or the taxable income for the year (which has been seriously calculated). Since this is Organic Foods (Pty) Ltd’s first year of assessment, they do not have a basic amount (i.e. a previous assessment) and must therefore use the calculated taxable income of R320 000.

QUESTION 3.2 (11 marks, 13 minutes)
Lovebird (Pty) Ltd is one of your clients. The financial year of assessment ends on the last day of March. Lovebird (Pty) Ltd is not considered a small business corporation as defined or a micro business. Lovebird (Pty) Ltd’s most recent tax assessments have been as follows:
- 2013 tax assessment (assessed on 1 September 2013), with taxable income of R200 000
- 2012 tax assessment (assessed on 1 December 2012), with taxable income of R160 000
The 2014 financial statements were finalised during July 2014. On 31 July 2014 the accountant calculated that the company would have a taxable income of R300 000 for the 2014 year of assessment.

REQUIRED:
Calculate all the provisional tax payments payable by Lovebird (Pty) Ltd for the 2014 year of assessment.
The new rules also have an effect on the following two sections of your study material:

1) **Tutorial letter 102 Question 3.2**

The answer in your study material for this question is based on the old rules. The following is the correct answer based on the new rules:

### 2014 First provisional tax payment

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic amount - taxable income as per 2013 Note 1</td>
<td>200,000</td>
</tr>
<tr>
<td>Normal tax payable x 28%</td>
<td>56,000</td>
</tr>
<tr>
<td>For six months (divide by 2)</td>
<td>28,000</td>
</tr>
</tbody>
</table>

The first provisional payment for 2014 is payable six months before the last day of the year of assessment, therefore 30 September 2013.

### 2014 Second provisional tax payment

The lower of the basic amount or an estimate of taxable income can be used:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic amount - taxable income as per 2013 Note 2</td>
<td>200,000</td>
</tr>
<tr>
<td>Estimate for 2014 - not available (at 31 March 2014), therefore use basic amount</td>
<td></td>
</tr>
<tr>
<td>Normal tax payable x 28%</td>
<td>(28,000)</td>
</tr>
<tr>
<td>Second provisional payment</td>
<td>28,000</td>
</tr>
</tbody>
</table>

The second provisional payment is due on the last day of the year of assessment, ending 31 March 2014.

### 2014 Third provisional tax payment

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual taxable income for 2014</td>
<td>300,000</td>
</tr>
<tr>
<td>Normal tax payable x 28%</td>
<td>84,000</td>
</tr>
<tr>
<td>Less: First provisional tax payment</td>
<td>(28,000)</td>
</tr>
<tr>
<td>Less: Second provisional tax payment</td>
<td>(28,000)</td>
</tr>
<tr>
<td>Amount due to SARS</td>
<td>28,000</td>
</tr>
</tbody>
</table>
The third provisional payment is due on 30 September 2014.

Notes:
1. The taxable income assessed in the 2013 assessment is used as the basic amount because it was received on 1 September 2013, more than 14 days before the provisional payment is to be made (i.e. 30 September 2013).

2. The basic amount for the 2014 second provisional payment does not need to be adjusted by 8% as the 2013 assessment is not more than 18 months before the current year (i.e. 2014 year end) and is not in respect of a period that ends more than one year after the end of the 2013 year of assessment.

2) DVD Question 2(a)

The DVD was recorded earlier in 2013 (before the legislation change was promulgated) and it therefore provides an incorrect answer to this provisional tax question. The solution in tutorial letter 201 has been revised to reflect the correct answer, and therefore you will notice a difference between the answer in the DVD and the answer in tutorial letter 201.

We have included another example below to help you to understand the new rules.

**Additional example:**

Using the same information as in tutorial letter 102 Question 3.2, let us assume that Lovebird (Pty) Ltd’s most recent tax assessments are as follows:

- **2012** tax assessment assessed on 21 September 2013 (instead of the 2013 tax assessment assessed on 1 September 2013), with a taxable income of R200 000
- **2011** tax assessment assessed on 2 February 2012 (instead of the 2012 assessment assessed on 1 December 2012), with a taxable income of R160 000

Then the provisional tax payments would be calculated as follows:

**2014 First provisional tax payment**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic amount - taxable income as per 2011 assessment</td>
<td>R 160,000 (Note 1)</td>
</tr>
<tr>
<td>Plus: (8% x 3 years)</td>
<td>R 38 400 (Note 2)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>R 198 400</td>
</tr>
</tbody>
</table>
Normal tax payable x 28% \[\text{R } 55,552\] (I)
For six months (divide by 2) \[\text{R } 27,776\] (I)

The first provisional payment for 2014 is payable six months before the last day of the year of assessment, therefore 30 September 2013.

**2014 Second provisional tax payment**

The lower of the basic amount or an estimate of taxable income can be used:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic amount - taxable income as per 2012 assessment</td>
<td>R 200,000</td>
</tr>
<tr>
<td>Estimate for 2014 - not available</td>
<td></td>
</tr>
<tr>
<td>(at 31 March 2014), therefore use basic amount</td>
<td></td>
</tr>
<tr>
<td>Normal tax payable x 28%</td>
<td>R 56,000</td>
</tr>
<tr>
<td>Less: First provisional payment</td>
<td>(R 27,776)</td>
</tr>
<tr>
<td>Second provisional payment due to SARS</td>
<td>R 28,224</td>
</tr>
</tbody>
</table>

The second provisional payment is due on the last day of the year of assessment, ending 31 March 2014.

**2014 Third provisional tax payment – due 30 September 2014**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual taxable income for 2014</td>
<td>R 300,000</td>
</tr>
<tr>
<td>Normal tax payable x 28%</td>
<td>R 84,000</td>
</tr>
<tr>
<td>Less: First provisional tax payment</td>
<td>(R 27,776)</td>
</tr>
<tr>
<td>Less: Second provisional tax payment</td>
<td>(R 28,224)</td>
</tr>
<tr>
<td>Amount due to SARS</td>
<td>R 28,000</td>
</tr>
</tbody>
</table>

**Notes:**

1. The taxable income assessed in the 2011 assessment is used as the basic amount because the 2012 assessment, even though it had been assessed on 21 September 2013 (i.e. before the first provisional payment was due), it was received within 14 days before the provisional payment is to be made (i.e. 30 September 2013).

2. The 2011 assessment is more than 18 months before the payment is due (i.e. from 2 February 2012 to 30 September 2013) and is in respect of a period that ends more than one year after the end of the 2013 year of assessment (preceding year of assessment). Therefore, the basic amount according to that assessment must be increased by 8% for each year, therefore 24%.
3. The basic amount for the 2014 second provisional payment does not need to be adjusted by 8% as the 2012 assessment is not more than 18 months before the payment is due (i.e. 21 September 2013 to 31 March 2014), although it is in respect of a period (the 2014 year of assessment) that ends more than one year after the end of the 2012 year of assessment (remember that both criteria must be met before the 8% increase is applied – refer the “AND” in point 3 on page 1 of this document).
Capital nature tests are often loosely grouped into two main groups:
- subjective tests
- objective tests

The subjective tests that are applied to determine whether an amount is of a capital nature or not are:
- nature of the receipts (the true nature of the transaction)
- sale of assets
- intention
- continuity (creating an asset or advantage that provides an enduring benefit)
- change of intention

When the courts look at objective tests (matters of fact) they will consider the following as indications:
- manner of acquisition
- period for which the asset is held
- manner of disposal
- nature of the asset disposed of
- reason for the receipt
- legal nature of the transaction
- accounting treatment of the transaction

**GROSS INCOME: SPECIAL INCLUSIONS**

4.3.1 Lease premiums
A lease premium is an amount that the lessee (person renting the property) pays to the lessor (person owning the property and who is renting it out) in addition to the monthly rental. It is a once-off payment usually at the beginning of the lease period. The full amount of the lease premium is included in the lessor’s income in the year of assessment in which it is received.

4.3.2 Leasehold improvements
A lease agreement may specify that the lessee is obliged to erect improvements on the leased land or to the leased buildings. This means that the person who is renting the property will incur costs to improve or extend the property, thereby increasing the value of the asset for the lessor (owner). The value of the improvements effected to the property must be included in the gross income of the lessor in the year of assessment in which the agreement was concluded. The value to be included is the amount stipulated in the lease agreement as the value to be expended on the lease improvements. If the actual value of the improvements (e.g. R700 000) is more than the amount stipulated in the agreement (e.g. R550 000), then the amount to be included in gross income remains the amount per the agreement (R550 000). (The lessee is able to claim a deduction for the leasehold improvements over the period of the lease – this will be dealt with in TAX3701.)

4.3.3 Proceeds from the disposal of certain assets
If a taxpayer sells an asset that was manufactured, produced, constructed or assembled by him, then the full proceeds received by him must be included in gross income. In other words, this disposal will not be treated as a transaction of a capital nature owing to the fact that he manufactured the asset. Note, that the proceeds will still be included in gross income, even if he used the asset as a capital asset and then disposed of it at a later stage.

4.3.4 Dividends
Any amount received or accrued by way of dividends (local and foreign dividends) is included in gross income. There are exemptions pertaining to certain dividends (dealt with in 4.4), but the dividend received or accrued must still be included in gross income first.

4.3.5 Key-man insurance policy proceeds
An insurance policy can be taken out on the lives of certain people in a business entity, for example the director or a specific employee. When this person is not available to the company any longer, then the policy will pay out an amount to the business entity. This amount is included in the gross income of the business entity, if the business entity was entitled to claim the insurance premiums in the current or
previous year of assessment (in terms of s 11(w) of the Income Tax Act, which is dealt with in TAX3701).

4.3.6 Recoupments
When a taxpayer sells a capital asset, the recoupment (for income tax purposes) pertaining to this transaction must be calculated. (This calculation is dealt with in study unit 6 of this module.) The recoupment amount must be included in gross income.

4.4 EXEMPT INCOME exempt income represents the income items that are included in gross income (either by means of the general definition or specific inclusions), but which should be deducted from gross income as a result of their tax-exempt status.

The types of income that are exempt for a South African enterprise are the following:
- dividends (see section 2.3.3 in the textbook)
- government grants (an amount received from government in terms of any programme or scheme that has been approved in the national annual budget process will be exempt from normal tax)

SELF-ASSESSMENT QUESTIONS

QUESTION 4.1 (17 marks, 20 minutes)
Sports Football (Pty) Ltd owns the Sports Football team. Sports Football (Pty) Ltd receives income in the form of gate sales and prize money. Recently it sold two players, namely, Big A and Star Ball, to Westville Football (Pty) Ltd. Big A was sold for R5 000 000 and Star Ball for R25 000.

Big A
Big A started playing football eight years ago for Sports Football under-24 team and, after signing a life-service contract, was trained by Sports Football (Pty) Ltd until he was considered to be the number-one striker in the country.

Star Ball
Star Ball was snapped up at a bargain price from Hasbeen Football Club for R3 000. When purchasing Star Ball, the board of directors of Sports Football (Pty) Ltd realised he would not suit the style of play used by its team, but anticipated being able to sell Star Ball at a quick profit. This happened only eight weeks after purchasing him.

REQUIRED: Discuss what amount, if any, Sports Football (Pty) Ltd should include in its gross income.

<table>
<thead>
<tr>
<th>REQUIRED:</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss what amount, if any, Sports Football (Pty) Ltd should include in its gross income.</td>
<td>17</td>
</tr>
</tbody>
</table>

QUESTION 4.1
Sports Football (Pty) Ltd
For an amount to be included in Sports Football (Pty) Ltd’s gross income the receipt or accrual must satisfy the requirements of the gross income definition (1). Gross income is defined as
- the total amount, (1)
- in cash or otherwise, (1)
- received by or accrued to or in favour of the resident, (1)
- during the year of assessment, and (1)
- not of a capital nature. (1)

The first four requirements of the gross income definition are satisfied with the receipts or accruals for the two players, Big A and Star Ball (1). You need to determine, however, whether the receipts or accruals are „of a capital nature“ (1). If the receipt is of a capital nature, then it would not be included in Sports Football (Pty) Ltd’s gross income.

In order to determine whether an amount received by a taxpayer is of a capital nature, one needs to determine whether the taxpayer’s intention (1) with the acquisition and subsequent disposal of the asset was that of investment (capital) or speculation (revenue).

Big A
It is clear that Big A was an income-producing asset (1) as far as Sports Football (Pty) Ltd was concerned. Sports Football (Pty) Ltd had been using Big A for a long period (eight years) (1) to produce income. Therefore, Big A must be regarded as a capital asset (1). The R5 000 000 received for Big A would be „of a capital nature” and would not be included in Sports Football (Pty) Ltd’s gross income (1). (A capital gain could arise on the disposal of Big A, but this issue is not part of the requirements of this particular question.)

**Star Ball**

It is equally clear that Star Ball was purchased as an asset with the intention of making a profit from his re-sale (1). Star Ball was purchased because of the bargain price asked for him and Sports Football (Pty) Ltd never intended to use Star Ball as an income-producing asset. The short time period that Star Ball was held also indicates a revenue intention (1). Star Ball was therefore sold in the undertaking of a profit-making scheme and is not of a capital nature (1). The R25 000 received for Star Ball would, therefore, be of a revenue nature and should be included in Sports Football (Pty) Ltd’s gross income (1).

**QUESTION 4.2 (14 marks, 17 minutes)**

The following case studies all contain an accrual amount. Apply the accrual principles to each of the above case studies to determine the date of accrual of the amount in question.

The principle involved in the determination of the date of accrual is the date when the taxpayer is entitled to the amount (1), as established in the People’s Stores court case (1).

**Springs CC**

Blue Water Ltd declared a final dividend of R12 a share on 14 February 2014 payable to share-holders registered in its share register on 1 March 2014. The dividend was actually paid on 15 March 2014. Springs CC holds 5 000 shares in Blue Water Ltd.

Springs CC becomes entitled to the dividend only if it holds the shares on 1 March 2014 (1). Therefore, the date of accrual is 1 March 2014 (1), even though the dividend is only payable 14 days later (1).

**Wire (Pty) Ltd**

On 1 January 2014 Wire (Pty) Ltd made a 6.5% fixed-deposit investment for 12 months with a local financial institution. The fixed deposit (together with interest) can only be withdrawn after the 12-month period has lapsed.

The interest on the fixed deposit accrues at the end of the 12-month fixed period. Until that time, Wire (Pty) Ltd has no right to any interest (1). Therefore, 31 December 2014 is the date of accrual of the interest (1).

**Fencing Ltd**

Fencing Ltd manufactures wood fencing. On 1 February 2014, it completed a wood fence to be erected around a cricket field. On 10 March 2014, this fence was sold for R50 000 and delivered to a cricket club.

An amount of R50 000 accrued on 10 March 2014 when the fence was sold (1), although no amount had been received by Fencing Ltd by that date (1).

**Watch-it (Pty) Ltd**

Watch-it (Pty) Ltd carries on the business of a building contractor specialising in the erection of sport pavilions. On 31 January 2014, it completed the building of a pavilion for the Blues Cricket Club. In terms of the building contract, 90% of the contract price is due and payable on completion of the pavilion and 10% of the contract price is to be retained as “retention moneys” until a final certificate is issued by the engineer six months after the completion of the pavilion. The contract price of the Blues Cricket Club contract is R4 500 000.

An amount equal to 90% of R4 500 000 (R4 050 000) accrued to Watch-it (Pty) Ltd on 31 January 2014 (1). The remaining 10% (R450 000) accrues only when the final engineer’s certificate is issued (1), which is not earlier than 31 July 2014.
Cotton Ltd sells sporting equipment. On 20 February 2014, it sold a set of night-cricket strips (shirts and flannels) on credit to a rugby club for R4 500. Cotton Ltd undertook to deliver the strips on 13 March 2014.

Also indicate the accrual principle and date of accrual if the delivery of the strip was a condition of the sale.

Cotton Ltd became entitled to the sale value of the night-cricket strip on 20 February 2014, which is when the contract of sale was concluded (1).

If the delivery of the strip had been a condition for the sale to be concluded, then there is an obligation on Cotton Ltd’s part to deliver the goods before it has a right to the sale price (1). If the goods were delivered on 15 March 2014, then that would be the date of accrual (1).

**QUESTION 4.3 (9 marks, 11 minutes)** Discuss whether the amounts referred to in each of the above case studies are included in the gross income of the respective taxpayers

(1) Stripes CC is a manufacturing business. The close corporation was the owner of a life policy taken out on the production supervisor (Sam). The policy matured on Sam’s 60th birthday (on 31 January 2014) and Stripes CC received R100 000. Sam retired shortly after his 60th birthday and Stripes CC used the R100 000 to give Sam a long-service award.

(1) Stripes CC received R100 000 from a key-man insurance policy. The proceeds from an insurance policy is capital in nature (1), therefore this amount will not be included in gross income according to the gross income definition (1). Stripes CC would have qualified for a tax deduction for the premiums on this policy (1) and the close corporation is thus required to include the R100 000 in its gross income in terms of the special inclusion provisions of the gross income definition (1).

(2) Lights (Pty) Ltd sold one of its manufacturing machines to another company for R50 000. On the date of sale the machine had a “nil” tax value and the accountant calculated that the tax recoupment from this transaction was R50 000.

(2) The manufacturing machine is an income-producing asset (1) and therefore the sale of this machine is capital in nature (1) and would not be included in the gross income of Lights (Pty) Ltd according to the gross income definition (1). However, the tax recoupment of R50 000 is required to be included in Lights (Pty) Ltd’s gross income (1) in terms of the special inclusion provisions of the gross income definition (1).

**QUESTION 4.4 (15 marks, 18 minutes)**

Property CC owns several buildings, which it rents out. On 1 January 2014, Property CC concluded a lease agreement with Desks (Pty) Ltd. The agreement provided for the following clauses:

- Desks (Pty) Ltd would pay Property CC a lease premium of R50 000 on the signing of the lease agreement on 1 January 2014.
- Desks (Pty) Ltd is obliged to improve the property to the extent of R500 000 by converting part of the warehouse into offices. The actual cost of the improvements was R525 000. The improvements were completed on 30 April 2014.
- Desks (Pty) Ltd would pay a monthly rental of R6 000 per month to Property CC. The building was used by Desks (Pty) Ltd from 1 January 2014, but the company only started paying the monthly rentals to Property CC on 1 May 2014 (after the leasehold improvements were completed).

**REQUIRED:**

| Discuss whether the amounts referred to in each of the above clauses should be included in the gross income of Property CC for the 2014 year of assessment. | 15 |

**Lease premium**

The premium received by Property CC is of a capital nature (1) and therefore does not form part of its gross income according to the gross income definition (1). However, a lease premium received is...
taxable (1) under the special inclusion provisions of the gross income (1). The R50 000 pre-mium is therefore included in gross income.

**Leasehold improvements**
The leasehold improvement on Property CC’s property is of a capital nature (1) and this amount will therefore not be included in gross income according to the gross income definition (1). However, in terms of the special inclusion provisions of the gross income definition (1), this amount is required to be included in Property CC’s gross income (1). The amount to be included in gross income is the amount stipulated in the agreement and therefore R500 000 (1) is taxable.
The accrual of the leasehold improvements takes place in the year of assessment when the right to have improvements effected has accrued to the lessor. The accrual therefore occurs on the date that the agreement is concluded (1).
As the R500 000 amount is stipulated in the lease agreement, the R500 000 accrued on the day the agreement was entered into, that is, 1 January 2014, and is therefore included in Property CC’s 2014 gross income (1).

**Rentals**
Rental income satisfies all the requirements of the gross income definition, as the total amount (1) is received by or accrued to or in favour of the resident (1) in cash or otherwise (1) during the year of assessment (1), and it is not of a capital nature (1).
The lease agreement was signed on 1 January 2014 and in terms of this agreement, rentals accrue from this date (1) at a rate of R6 000 a month. The fact that payment of the rentals occurs only from 1 May 2014 does not alter the fact that rentals of R6 000 a month accrued to Property CC as from 1 January 2014 (1). Two months of rentals, amounting to R12 000 in total, are therefore included in gross income for the 2014 year of assessment (1).

**STUDY UNIT 5**

Before an expense may be claimed as a deduction it must qualify as an allowable deduction in terms of the Income Tax Act.

Deductions for income tax purposes and accounting expenses will differ in some instances because deductions are provided for in the Income Tax Act and expenses are provided for by IFRS. This means that taxable income will not be the same as the accounting net profit for any year.

The Act makes provision for the general deduction formula in terms of which most operating expenses incurred by the taxpayer during the operation of an entity may qualify as allowable deductions.

**The principle: Expenditure** is to be regarded as part of the cost of performing income-earning operations or as part of the cost of establishing or improving or adding to the income-earning structure, the so-called “operations-versus-structure” test. The other tests used to help decide the matter were the “fixed-versus-floating capital” test, the test to establish whether there was any enduring benefit or permanent asset created by the expenditure and even the recurrence test.

**Floating capital expenditure** takes place when expenditure frequently changes its form from money to goods with the purpose of making a profit. This represents a deductible expense and one example is the purchase of stock.
Fixed capital expenditure represents capital expenditure that may qualify for capital allowances, for example machinery, the cost of such machinery will not be deductible in terms of the general deduction formula.
THE GENERAL DEDUCTION FORMULA REQUIRES:

- A trade be carried on
- Income to be derived from such a trade
- Expenditure and losses
- Actually incurred
- During the year of assessment
- In the production of income
- Not of a capital nature

As long as the purpose of the expense is to enable the taxpayer to earn income, the income may be earned in a later year – the expenditure is still deductible in the earlier year.

THE GENERAL PROHIBITED DEDUCTIONS:

- Any money claimed as a deduction
- To the extent to which
- The money are not laid out or expended for the purposes of trade

Tests for expenditure of capital nature may be summarised as being where:

- It adds to the taxpayer's income-earning structure
- It is a once-off expense from which future benefits (income) will flow
- It creates an enduring benefit or advantage for the taxpayer

SPECIFIC DEDUCTIONS – LEGAL EXPENSES

In order to qualify for the deduction of legal expenses the costs must be:

- Actually incurred
- In respect of any action, claim, dispute or action of law
- In the course of, or by reason of, ordinary operations in carrying on trade; and
- Not of a capital nature

1. Legal expenses allowed as per above description

- Fees for legal practitioners
- Expenses incurred in order to procure evidence or expert advice
- Court fees
- Taxing fees, witness fees and expenses
- The costs of sheriffs and messengers of the court; and
- Any other similar costs
For the total legal fees of R6 000 incurred, total compensation of R60 000 was received. R10 000 received relating to lost revenue over the total R60 000 represents "one-sixth". Therefore, only one-sixth (1/6) of the legal fees incurred can be claimed under section 11(c), as the other portion is of a capital nature.

One of Dunlop (Pty) Ltd’s workers lost a finger while operating a machine in its factory. In January 2014, the court granted the worker compensation amounting to R10 000. Dunlop (Pty) Ltd paid the compensation in April 2014 only, following its year end on 31 March 2014.

Is the R10 000 compensation deductible? Cover up the solution and see if you can argue whether the expense of R10 000 is deductible or not.

Solution

In addition to satisfying the other requirements of the general deduction formula, an expense must be incurred in the production of income. Is the compensation paid so closely connected with Dunlop’s income earning operations? It would appear that the risk of injury to its employees operating machines in the factory is closely connected to the production of Dunlop’s income. It could therefore be said that the expense was an inevitable concomitant of Dunlop’s type of business.

Was the expense actually incurred at year-end, since it was only paid in April 2014? Although the expense was paid in the following year of assessment, the company’s liability had been fixed by the court and was therefore unconditional as of January 2014 and was therefore actually incurred and deductible in the 2014 year of assessment.

2. **Restraint of Trade payments**

- Any amount actually incurred by a person
- In the course of carrying on of his trade
- As compensation in respect of any restraint of trade imposed on any natural person
- To the extent that the amount constitutes or will constitute income of the person to whom it is paid

LIMIT – deduction shall not exceed in any one year the lesser of:

- The amount incurred divided by the number of years or part thereof, during which the restraint will apply; or
- One third of the amount incurred

*(note that the deduction is not apportioned if the expense is incurred part way through the tax year)*

Paid Mrs Y R3m to restrain him from working for a competitor for 3 years in Jan2014

Mrs Y $ R3m ÷ 3 years = R1m claimable in the 2014, 2015 and tax years

Mrs Y’s restraint-of-trade deduction is over 3 years, as the R3 million divided by 3 years gives R1 million, which is less than the R3 million divided by 2.5 years, which gives R1.2 million.

3. **REGISTRATION of patents, copy rights, designs and trademarks**

Allows a deduction in respect of expenditure actually incurred in:

- Obtaining the grant of any patent
- The restoration of any patent
- The extension of the term of any patent
- The registration of any copyright
- The extension of the term of any copyright
- The registration of any design
- The extension of the registration period of any design
- The renewal of the registration of any trade mark

If such property is used by the taxpayer in the production of his income or income is derived therefrom. NOT ACQUISITION COST AS IT IS DEALT WITH IN SECTION 11(gC)

4. **ACQUISITION of patents, copy rights, and designs**
- If the expenditure is less or equals R5,000 it is deducted in full in the year the asset is brought into use for the first time
- If the expenditure exceeds R5,000 the allowance is:
  - 5% p/a of the expenditure, in the case of a PATENT, COPYRIGHT OR SIMILAR PROPERTY (INCLUDING KNOWLEDGE AND KNOWLEDGE RIGHTS)
  - 10% p/a of the expenditure, in the case of a DESIGN OR SIMILAR PROPERTY (INCLUDING KNOWLEDGE AND KNOWLEDGE RIGHTS)

5. **Research and development expenditure**

**Actual deduction - Research and development expenditure**
- 100% of R&D expenditure
- Actually incurred
- Directly and solely in respect or R&D undertaken in SA
- In the production of income
- And the carrying on of any trade

**Additional deduction - Research and development expenditure**
A company can qualify for an additional 50% deduction if:
- The R&D is approved by the minister
- The expenditure is incurred in respect of R&D carried on by that taxpayer and
- The expenditure is incurred on or after the date of receipt of the application by the Department of Science and Technology for approval of that R&D

**R&D done by third party**
If the taxpayer incurs expenditure to fund another person’s R&D, which is conducted on behalf of the taxpayer, the taxpayer qualifies for the additional deduction of 50% of the R&D if:
- The R&D is approved by the minister
- The expenditure is incurred in respect of R&D carried on by that taxpayer and
- The expenditure is incurred on or after the date of receipt of the application by the Department of Science and Technology for approval of that R&D

**Non Qualifying Research and development expenditure**
- Market research, testing or sales promotion
- Administration, financing, compliance or similar expenditure
- Routine testing, analysis, collection of information or quality control in the normal course of business
- Development of internal business processes unless those internal business processes are intended for sale or for granting the use or right of use or grant of permission to use thereof
- Social science research, including arts and humanities
- Oil and gas or mineral exploration or prospecting, except R&D carried on to develop technology used for that exploration or prospecting
- The creation or development of financial instruments or financial products
- The creation or enhancement of trademarks or goodwill and
- Any expenditure contemplated in section 11(gB) or (gC)

**Question**
Alpha Ltd often carries out mining innovation activities in South Africa. They subcon-tract with Beta Ltd to perform research trials to create new mining tools on their be-half. Alpha Ltd is solely responsible for determining the research methodology applied. The trials commence on 1 April 2014 at a cost of R300 000. Beta Ltd charges Alpha Ltd, R360 000 (cost plus a mark-up). Beta Ltd incurred further costs of R80 000 on 16 July 2014, which they charged Alpha Ltd R96 000 for. The required approval for the project was 1 May 2014.

**REQUIRED:**
Calculate the research and development deductions Alpha Ltd and Beta Ltd can claim for the year of assessment ending 31 December 2014 (assume only eligible research costs were incurred).

### Alpha Ltd

**Automatic deduction (100%)** (R360 000 + R96 000)  
456 000

**50% additional allowance:**
- on R360 000 (Note 1)  
nil
- on R96 000 (R96 000 × 50%)  
48 000

**Total**  
504 000

### Beta Ltd

**Automatic deduction (100%)** (R300 000 + R80 000)  
380 000

**50% additional allowance (Note 2)**  
nil

**Total**  
380 000

**Notes**

1. Research and development costs incurred before the date of receipt of the application by the Department of Science and Technology for approval do not qualify for the 50% additional allowance. Therefore, Alpha Ltd cannot claim an additional allowance on the R360 000 as this was incurred before the date of receipt of the application for approval on 1 May 2014.

2. Only the company responsible for determining or altering the research methodology can claim the 50% additional allowance. Therefore, the allowance is available only to Alpha Ltd.

### 6. **Bad debts**

A bad debt deduction can only be claimed as long as the debt gave rise to income (as defined, i.e. gross income less exempt income):
- Are due to the taxpayer
- Have during the year of assessment become bad and
- Are in respect of amounts which have been included in the taxpayer’s income in the current or any previous year of assessment, i.e. the supply which gave rise to the debt which gave rise to gross income

All 3 these conditions must be fulfilled in order for the debt to qualify for deduction.

### 7. **Doubtful debts**

- Taxpayer must supply a detailed list of doubtful debts to SARS. A deduction of 25% is allowed to the list.
- If a doubtful debt deduction is claimed in one year, it must be added back to income in the following year.

### 8. **Contributions by an employer to pension, provident and benefit funds**

You would have noticed that this contribution is limited to 10% of the employee’s remuneration during a year of assessment. However, in practice the commissioner allows a limitation of up to 20% of the employee’s remuneration. In an exam, you will be expected to use 10%, as prescribed by legislation. Students who choose to use 20% will be penalised.

### 9. **Donations to Public Benefit Organisations (PBOs)**

A donation deduction can only be allowed if it is supported by a section 18A receipt/certificate issued by the recipient of the donation to a registered PBO in terms of Part II of the Ninth Schedule.
Deduction of maximum 10% of the taxable income of the taxpayer before the deduction under this section and section 18 (medical expenditure) and excluding the taxable income from any retirement lump sum benefit.

Due to the fact that the donation deduction is based on taxable income, this deduction must always be the last line of your taxable income calculation.

Details to reflect on the receipt of a donation

- Reference number, issued by the Commissioner, of the public benefit organisation, institution or board
- Date of the receipt of the donation
- Name of the public benefit organisation, institution or board
- Name and address of the donor
- Amount of the donation or nature of the donation if not cash
- Certification that the receipt is issued for the purposes of section 18A

10. **Annuities paid to former employees on retirement**

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**PROHIBITED DEDUCTIONS – never deductible**

- insured losses (section 23(c))
- tax, penalties and interest on tax (section 23(d))
- provisions (section 23(e))
- expenses to produce exempt income (section 23(f))
- non-trade expenditure (section 23(g))
- restraint of trade payments (section 23(l))
- fines and corrupt activities (section 23(o))

**PREPAID EXPENSES**

- In terms of section 23H, prepaid expenditure can be claimed in the year of assessment that the full payment is made if
  - the prepaid amount relates to a period within 6 months after year end **OR**
  - the prepaid amounts (in total) are less than R100 000

Therefore, if any of the two criteria above applies to the prepayment, then the whole expense (i.e. the portion incurred in the year of assessment and well as the prepaid portion) can be claimed in the year of assessment it was paid in.

If these rules are applied to the above example, then you can determine that the pre-paid amount relates to 9 months after year end (more than 6 months, thus not deductible in the current year according to the first criterion) and the prepaid amount is R75 000 (less than R100 000, thus deductible in the current year according to the second criterion). Note that only the prepaid expense (R75 000) is taken into account for the application of these rules and not the full amount paid (R100 000). The prepaid expense of R75 000 will thus be deductible in the current year of assessment, because one of the criteria was met.

The R25 000 incurred in the current year, as well as the R75 000 prepaid expense, can be claimed in the current year. Although the full amount of R100 000 is thus deductible, you must show the two portions of the amount (i.e. the current year expense and the prepaid expense) separately in your tax calculation.

**Work through the example in section 4.5.**

Did you notice that the R240 000 for the insurance premiums cannot be claimed in full, but must be spread over the year and matched to the period in which the service is delivered? This is because the prepaid period, namely March 2013 to February 2014, is more than 6 months after the year end and
the total prepaid portion of the expense of R150 000 (R180 000/6 x 5 months prepaid) and R20 000 (R24 000/12 x 10 months prepaid) are in total greater than R100 000.

TRADING STOCK

Closing stock is income in the hands of the entity and section 22(2) provides that the opening stock may be deducted.

For taxation purposes, the Act does not make provision for the deduction of the cost of sales. Each of the three components must be shown separately in the calculation of taxable income.

Closing stock held and not disposed of at year-end must be accounted for at the lower of cost or market value, if the market value is lower than cost because of damage, deterioration, or any other reason satisfactory to the Commissioner.

In the example, you will notice that the mark up of R40 000 is, in effect, what is being taxed in the year in which the vehicle (stock) is sold.

Opening stock

In the example, the moment the company changes its intention with regards to land and no longer holds the asset as a capital asset, but as trading stock, the market value of the land as at the date of the change is included in opening stock.

Manufactco (Pty) Ltd purchased stock for R60 000. It incurred handling fees of R3 500 and paid a transporter R2 500 to deliver the stock.
Calculate the cost price of the stock for tax purposes.

Solution

R

- Purchase price 60 000
- Plus: Handling fees 3 500
- Transport 2 500
- Cost price 66 000

Stock acquired for no consideration, private and domestic consumption

Trading stock which cost the taxpayer R6 000 is removed by him for private use. The market value of the stock on the date it was used was R8 000. What is the effect of this on taxable income?

Solution

The taxpayer must include a recoupment (taxable amount) of what he was previously allowed to deduct, namely, R6 000 in taxable income.

If the taxpayer donated the trading stock (and the donation qualifies for a deduction) — what would the effect be on taxable income?

Solution

The taxpayer would recoup and include R6 000 in taxable income.

Textbook: sections 4.7 – 4.8

This is a good example of the kind of question you can expect to get in the exam.

SELF-ASSESSMENT QUESTIONS

QUESTION 5.1 (58 marks 70 minutes)
Case study 1 (33 marks, 40 minutes)
REQUI
[549x52]43
[35x802]RED:
[494x802]MARKS
[35x789]33

Briefly discuss whether the following expenses would be deductible or not by Lazarus CC in terms of the general deduction formula section 11(a) and section 23 (prohibited deductions) of the Income Tax Act. Refer to relevant case law if appli-cable. List the requirements where necessary.

Lazarus CC is a panel-beating service run from the home of Mr Lazarus, the only member of the CC. The garage attached to the house is used exclusively for trade purposes.
Lazarus CC entered into the following transaction and is uncertain as to how to treat it for taxation purposes:
1. Expenditure incurred to have the garage door fixed because the motor broke (this was recovered from the CC’s insurance). (2 marks)
The cost of repairing the garage door will not be deductible because section 23(c) prohibits the deduction of any loss or expenditure that is recoverable under any contract of insurance. As the deduction is prohibited section 11(a) requirements do not need to be applied.

2. Penalties and interest incurred because the CC failed to pay unemployment insurance contributions (UIF). (2 marks)
The amount would not be deductible because penalties and interest on Unemploy-ment Insurance Contributions (UIF) are prohibited from being deducted (section 23(d)). Therefore, you would not need to determine if the expense would meet the general deduction in section 11(a).

3. A restraint of trade payment on the CC’s previous member, so that the partner could not open another panel-beating service within a 20 km radius of the house. (2 marks)
The restraint of trade payment is prohibited from being deducted (section 23l). Therefore, you would not need to determine if the expense would meet the general deduction in section 11(a).

4. Monthly rental paid on a facsimile (fax) machine. (11 marks)
The requirements of the general deduction formula are:
- Expenditure – in this case there is an amount
- Actually incurred – the amount is a monthly payment, therefore it is actually incur-red
- In the production of income – in this case it relates closely to the running of the business and therefore, is in the production of income.
- Not of a capital nature – the expense relates to a capital asset (the fax machine), it’s not for the purchase of the machine but merely the rental thereof, which is a recurrent/monthly expense and is closely connected to the income earning operations and not structure (New State Areas Ltd). Therefore, the expense is not of a capital nature.

There is no section 23 that prohibits this deduction.
Therefore, the expense meets all the requirements of the general deduction formula and will be deducted for income tax purposes.

5. Expenditure incurred to build on a room onto the existing garage with the intention of Lazarus CC renting it out to its employees as and when required. (16 marks)

Case study 2 (12 marks, 14 minutes)

REQUIRED:
Briefly discuss the deductibility of the amounts in the above transactions in terms of the general deduction formula for the 2014 year of assessment. Ignore case law. List all the requirements where necessary.

The following transaction relates to Rozac (Pty) Ltd:
On 1 October 2013, Rozac (Pty) Ltd acquired an exclusive right, for a period of five years, to sell a certain product in the area in which its business is situated. The cost of this right was R150 000, payable in five equal annual instalments.

The requirements of the general deduction formula are:
- **Expenditure** – in this case there is an amount of R150 000
- **Actually incurred** – the amount is paid in installments (with no condition attached) therefore, it is actually incurred
- **In the production of income** – in this case it relates closely to the running of the business and therefore, is in the production of income.
- **Not of a capital nature** – The exclusive right to sell the product in its trading area for a period of five years relates to the establishment of an income-producing asset (as opposed to the cost of performing the taxpayer’s income earning operations). The expense is of a capital nature. The fact that the expense is paid in installments does not change its capital nature.

There is no section 23 that prohibits this deduction. Therefore, the expense does not meet all the requirements of the general deduction formula and will not be deducted for income tax purposes.

**Case study 3 (13 marks, 16 minutes)**

**REQUIRED:**
Discuss the deductibility of both the rentals in terms of the general deduction formula for the current year of assessment (28 February 2014). List all the requirements where necessary.

Martínez Hair Studio CC is a hairdressing salon. The salon is run from a shop that is situated in a shopping centre. The salon pays monthly rental for the shop of R10 000 on the 28th of each month. Apart from the set monthly rental, it also pays a 2% rental based on the annual turnover for the period 1 April 2013 to 31 March 2014 if the turnover exceeds R500 000. The turnover for the current year of assessment, as at the end of February 2014, amounted to R485 000.

**Monthly rental expenditure**
The monthly rental of R10 000 is actually incurred and will be deductible as it meets all the other general deduction requirements.

**Annual turnover rental of 2%**

The requirements of the general deduction formula are:
- **Expenditure** – in this case there is an amount to be paid, i.e. 2% of the turnover, if it exceeds R500 000.
- **Actually incurred** – The rental based on the annual turnover exceeding R500 000 is dependent on a condition - whether the turnover will exceed R500 000 at the end of 31 March 2013. There is no definite and absolute liability to pay this amount at year end (28 February 2013), as there is no way of knowing whether the annual turnover will exceed R500 000. Therefore, the expenditure has not been incurred.
- **In the production of income** – in this case it relates closely to the running of the business and therefore, is in the production of income.
- **Not of a capital nature** – This relates to the rental expenditure (operating expense) per the rental agreement and is not of a capital nature.

There is no section 23 that prohibits this deduction. Therefore, the expense does not meet all the requirements of the general deduction formula and will not be deducted for income tax purposes.

**QUESTION 5.2 (13 marks, 16 minutes)**
Twizzers (Pty) Ltd manufactures sweets. It is not considered a small business corporation, as defined, for income tax purposes. The taxable income of the company before the following transactions were taken into account for the year of assessment ending 30 April 2014 amounted to R1 410 000 (ignore any VAT implications):

1. The following legal costs were incurred during the year of assessment:
   ➢ Legal costs relating to the collection of long outstanding debtors to the amount of R5 677.

   ➢ Costs to draw up a lease contract amounting to R2 800. This contract relates to the lease of a factory from a third party for a period of 10 years. Twizzers (Pty) Ltd is the lessee.

   ➢ Court representations and witness fees arising from a court case which was settled during June 2013. Twizzers (Pty) Ltd was ordered to pay damages to a client after the client’s child accidentally contracted food poisoning from a product owing to negligence during the manufacturing process. The legal costs amounted to R40 000.

2. An invention, to be used in the business, was developed during the year of assessment by Twizzers (Pty) Ltd, following extensive research. The expenses of the development amounted to R68 000. The company received no external funding for the research.

3. A trademark, GIZZ, was purchased on 1 January 2013 for R100 000. The expected useful life of the trademark was 8 years. On 1 December 2013, the company also renewed the registration period of its WHIZZ trademark for another 5 years at a cost of R3 000.

4. Twizzers (Pty) Ltd would like to claim bad debts and a doubtful debts allowance. SARS grants an annual allowance of 25% to Twizzers (Pty) Ltd based on the list of doubtful debts at year end. The debtor statistics were as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Bad debts recovered</th>
<th>List of doubtful debts at year end</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>-</td>
<td>10 000</td>
</tr>
<tr>
<td>2013</td>
<td>500</td>
<td>16 000</td>
</tr>
<tr>
<td>2012</td>
<td>1 000</td>
<td>9 000</td>
</tr>
</tbody>
</table>

Outstanding debtors at year end (before bad debts were deducted) were as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>R38 600</td>
</tr>
<tr>
<td>2014</td>
<td>R48 000</td>
</tr>
</tbody>
</table>

Bad debts for the past two years were as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>R 4 600</td>
</tr>
<tr>
<td>2014</td>
<td>R12 000</td>
</tr>
</tbody>
</table>

A debtor, Fizzpops CC, was placed in liquidation during January 2014. Fizzpops CC paid its creditors 50c in the rand. Fizzpops CC’s debt owing to Twizzers (Pty) Ltd at year end amounted to R16 000. **This amount is not included in the above bad debts or list of doubtful debts for 2014.**

5. Dividends to the amount of R20 000 were distributed to the only shareholder, Mr Whizz, and a salary of R180 000 was paid to him for the 2014 year of assessment.

6. Provisional tax payments for the 2014 year of assessment amount to R100 000.

**REQUIRED:**

<table>
<thead>
<tr>
<th>MARKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calculate the <strong>income tax liability</strong> for the 2014 year of assessment for Twizzers (Pty) Ltd. If an amount is not deductible, give a brief reason.</td>
</tr>
</tbody>
</table>
Calculation of the income tax liability for the 2014 year of assessment for Twizzers (Pty) Ltd

<table>
<thead>
<tr>
<th>Taxable income (given)</th>
<th>R 1 410 000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legal fees:</strong></td>
<td></td>
</tr>
<tr>
<td>- Debtors</td>
<td>(5 877) (1)</td>
</tr>
<tr>
<td>- Lease contract</td>
<td>nil (1)</td>
</tr>
<tr>
<td>- Damages claim</td>
<td>nil (1)</td>
</tr>
<tr>
<td>Research costs</td>
<td>(102 000) (1)</td>
</tr>
<tr>
<td>Trademark GIIZZ</td>
<td>nil (1)</td>
</tr>
<tr>
<td>Trademark WHIZZ</td>
<td>(3 000) (1)</td>
</tr>
<tr>
<td>Bad debts</td>
<td>(20 000) (1)</td>
</tr>
<tr>
<td>Doubtful debt allowance:</td>
<td></td>
</tr>
<tr>
<td>2013: R16 000 x 25%</td>
<td>(4 000) (1)</td>
</tr>
<tr>
<td>2014: R10 000 x 25%</td>
<td>(2 500) (1)</td>
</tr>
<tr>
<td>Dividends</td>
<td>nil (1)</td>
</tr>
<tr>
<td>Salary</td>
<td>(180 000) (1)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>1 100 823 (1)</td>
</tr>
<tr>
<td>Tax payable @ 28%</td>
<td>308 230 (1)</td>
</tr>
<tr>
<td><strong>Less: Provisional tax</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Tax liability</strong></td>
<td>208 230 (1)</td>
</tr>
</tbody>
</table>

**QUESTION 5.3 (13 marks, 16 minutes)**

Blueberry (Pty) Ltd is in the cell phone industry and provides cell phone reception and call services. It has an extensive customer base, which has been created over the past few years. The current financial year ends on 30 June 2014. You can assume that current legislation applies to Blueberry (Pty) Ltd.

The following information relates to Blueberry’s activities for the current financial year:
1. Gross income amounts to R2 240 000, before taking the information below into account.
2. Blueberry’s employees belong to the company’s pension fund and medical aid fund. Blueberry contributes to these funds on behalf of the employees. During the year, contributions on behalf of the employees to the pension fund amounted to R110 000 and to the medical aid fund R135 000. Blueberry’s total remuneration approved by the Commissioner is R2 350 000.
3. The financial manager, Mr Grey, resigned on 31 July 2012. To prohibit him from trading in direct competition to Blueberry, the company paid him an amount of R550 000 as compensation for his restraint of trade for the following 5 years. The full amount was included in Mr Grey’s income on his 2013 income tax return.
4. The debtors clerk indicated that the doubtful debts amounted to R2 500 000 at the end of the year. The Commissioner will allow a doubtful debt allowance of R625 000 in the current year. The doubtful debt allowance claimed in the 2013 year of assessment amounted to R760 000.
5. Legal fees to the amount of R140 000 were incurred for the following:
   - Collection of outstanding trade debtors ........................................... R 85 000
   - Court cases in respect of employee remuneration claims ....................... 55 000
   (Note: employee remuneration is deductible for purposes of this question.)

6. Penalties and interest paid to SARS amounted to R16 000 in respect of the current year of assessment.

7. Bad debts written off consist of the following:
   - Loan to director ........................................................................ R 80 000
   - Trade debtors ............................................................................ 122 000

8. The following prepaid expenditure was incurred:
   - Rental of the switchboard system for head office for the period
     1 July 2014 to 31 January 2015 .................................................... 40 000
   - Deposit for the purchase of a delivery vehicle that will be delivered
     on 1 September 2014 .................................................................. 85 000

---

**REQUIRED:**

<table>
<thead>
<tr>
<th>MARKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>13</td>
</tr>
</tbody>
</table>

Calculate the **taxable income** of Blueberry (Pty) Ltd for the year of assessment ended 30 June 2014. Show all calculations. Items which are not taxable or deductible should be indicated clearly as such and a brief reason given. Round off all amounts to the nearest rand. Ignore any VAT implications.

---

**QUESTION 5.3**

**Calculation of the taxable income of Blueberry (Pty) Ltd for the year of assessment ended 30 June 2014**

<table>
<thead>
<tr>
<th></th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>2 240 000</td>
</tr>
<tr>
<td>Contribution to funds (R110 000 + R135 000) = R245 000</td>
<td>(235 000)</td>
</tr>
<tr>
<td>Restraint of trade payment</td>
<td>(less of: R550 000/5 years or R550 000/3 years)</td>
</tr>
<tr>
<td>Doubtful debt allowance – 2013</td>
<td>760 000</td>
</tr>
<tr>
<td>Doubtful debt allowance – 2014</td>
<td>(625 000)</td>
</tr>
<tr>
<td>Legal costs – collection costs</td>
<td>(85 000)</td>
</tr>
<tr>
<td>- court cases</td>
<td>(55 000)</td>
</tr>
<tr>
<td>Penalties and interest - not deductible as it is prohibited by s23</td>
<td>nil</td>
</tr>
<tr>
<td>Bad debts</td>
<td>nil</td>
</tr>
<tr>
<td>- loan to director (not previously included in income, therefore not a bad debt)</td>
<td>(nil)</td>
</tr>
<tr>
<td>- trade debtors</td>
<td>(122 000)</td>
</tr>
<tr>
<td>Pre-paid expenses</td>
<td>(40 000)</td>
</tr>
<tr>
<td>- rent (7 months &gt; 6 months, but less than R100 000, therefore not a prepaid expense, deductible in full)</td>
<td>nil</td>
</tr>
<tr>
<td>- deposit (capital expenditure)</td>
<td>nil</td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td><strong>1 728 000</strong></td>
</tr>
</tbody>
</table>
QUESTION 5.4 (11 marks, 13 minutes)

Beauty (Pty) Ltd is a business that manufactures jewellery. It is not regarded as a small business corporation as defined for income tax purposes. Beauty (Pty) Ltd’s accountant has asked for your assistance with the following items with regards to calculating taxable income.

Beauty (Pty) Ltd has a year of assessment ended 31 March 2014.

Taxable income before the items below have been taken into account is R2 910 000.

### Outstanding Items

<table>
<thead>
<tr>
<th>Description</th>
<th>Notes</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Tax deductible</td>
<td></td>
<td>180 000</td>
</tr>
<tr>
<td>- Legal expenses</td>
<td>1</td>
<td>25 000</td>
</tr>
<tr>
<td>- Bad debts</td>
<td>2</td>
<td>45 000</td>
</tr>
<tr>
<td>- Restraint of trade</td>
<td>3</td>
<td>200 000</td>
</tr>
<tr>
<td>- Insurance</td>
<td>4</td>
<td>12 500</td>
</tr>
</tbody>
</table>

### Notes:

1. **Beauty (Pty) Ltd incurred the following legal expenses:**
   - Labour negotiations                      20 000
   - Legal appeal to SARS regarding imposed tax 5 000
   - **Total legal expenses:** 25 000

2. **Bad debts written off consist of the following:**
   - Trade debtors                            25 000
   - Loan to an employees to buy a motor vehicle 20 000
   - **Total bad debts:** 45 000

The financial accountant tells you that included in the list of outstanding debtors at year end, is an amount of R22 000 that is considered doubtful. The previous year’s doubtful debts were R15 000. A doubtful debts allowance was claimed for tax purposes for 2013.

3. On 1 May 2013, the managing director of Beauty (Pty) Ltd decided to take early retirement. Subsequently, Beauty (Pty) Ltd paid him an amount of R200 000 restraining him from doing the same business after retirement for a period of two years.

4. Beauty (Pty) Ltd paid an annual insurance premium of R50 000 for the period 1 January 2014 until 31 December 2014.

### REQUIRED:

Calculate the taxable income of Beauty (Pty) Ltd for its year of assessment ended 31 March 2014.

Show all calculations. Items which are not taxable or deductible should be indicated clearly as such and a brief reason given. Round off all amounts to the nearest rand. Ignore any VAT implications.

<table>
<thead>
<tr>
<th>ITEM</th>
<th>MARKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calculate the taxable income of Beauty (Pty) Ltd for its year of assessment ended 31 March 2014.</td>
<td>11</td>
</tr>
</tbody>
</table>


QUESTION 5.5 (11 marks, 13 minutes)
Veli Jeans (Pty) Ltd manufactures and sells fashionable jeans and jackets. The company’s financial year ends on 31 March. The following information has not been dealt with by the accountant in calculating the 2014 taxable income:

1. General income and expenses
   Veli Jeans (Pty) Ltd’s income from sales is R7 500 000.
   The manufacturing and acquisition cost of stock during the year of assessment amounted to R3 500 000.

2. Closing stock
   Jeans
   The following costs were incurred in respect of manufactured jeans stock on hand at 31 March 2014 and not disposed of, as counted and calculated by the auditors at five o’clock (these costs are included in the total manufacturing and acquisition cost of R3 500 000 above):
   - Direct materials and labour 1 900 000
   - Maintenance of manufacturing machines 400 000
   - Bonus: marketing manager 500 000
   On the evening of 31 March 2014 there was a heavy rainstorm. The roof of one of the store-rooms leaked onto some of the jeans stock and caused damage to these items to the amount of R250 000.

3. Jackets
   Veli Jeans (Pty) Ltd bought blue jackets from an agent in Cape Town. The cost incurred in acquiring these items is R800 000. Transport costs of R10 000 were also paid to get the stock to Johannesburg. Both these expenses are included in the manufacturing and acquisition cost of R3 500 000 above.
   During the SA Fashion Week the company was shocked to discover that there had been a sudden change in fashion: blue jackets are now out of fashion and only black jackets are in demand. Veli Jeans (Pty) Ltd estimates that the value of jacket stock has now diminished by R600 000 as a result of these unforeseen circumstances. None of the blue jackets had been sold at year end.

4. T-shirts
   The CEO of Veli Jeans (Pty) Ltd (Jeepee) has a brother (Pololo) who owned a clothing shop. Pololo closed down his business in January 2014 and donated all of his T-shirts to Veli Jeans (Pty) Ltd. Pololo acquired the T-shirts at a cost of R300 000, but the market value on the date of donation was R200 000. None of these T-shirts had been sold at year end.
   The cost of closing stock at 31 March 2013 was R955 000 and the market value was R1 000 000 on the same date.
Calculate the taxable income of Veli Jeans for the 2014 year of assessment by taking the outstanding items left by the accountant into account. Show all calculations. Items that are not taxable or deductible should be indicated clearly as such and a brief reason given. Round off all amounts to the nearest rand. Ignore any VAT implications.

**STUDY UNIT 6 - Capital allowances**

As you know the purchase price of an asset is not deductible for income tax purposes. Instead the cost is spread over the estimated life of the asset and deducted as a capital allowance.

**REPAIRS AND IMPROVEMENTS**

Part of the cost of holding an asset is to keep it in good working order. Capital assets include the cost of improvements to the capital asset, but exclude the cost of repairs to restore the asset to its original state. Repairs mainly constitute damage or deterioration to capital assets, and the intention of the taxpayer is to restore the assets to its original condition, whereas an improvement is the creation of a better asset.

Study section 5.2 and work through the example on repairs and improvements.

**CAPITAL ALLOWANCES – Movable assets**

Special capital allowance – section 12C
Section 12C provides for special wear-and-tear allowances on new or used plant and machinery used directly in the process of manufacturing or a similar process by a taxpayer and brought into use for the first time by the taxpayer in his trade. A process must, however, meet certain criteria before it may qualify as a process for income tax purposes. These favourable allowances are aimed at stimulating the manufacturing sector in order to create job opportunities in our country. Please note that any moving or installation cost relating to manufacturing machines are added to the cost of the machine. If moving costs are incurred on an asset still being written off, such costs will be written off over the remainder of the write-off period. If the asset has been fully written off, the moving costs incurred will be fully deductible during the year they were incurred.

Always remember that a section 12C allowance can never be apportioned.

Assets belonging to small business corporations – section 12E
The tax benefit for this category of taxpayer comprises a favourable capital allowance in respect of manufacturing assets (100% deduction) and non-manufacturing assets (50% in year one, 30% in year two and 20% in year three), as well as a favourable income tax rate (as discussed in study unit 3). Note that moving costs applicable to assets qualifying for this allowance are fully deductible when incurred.

Note that both new and used (second-hand) assets may qualify for the section 12E capital allowance. Study unit 5.5
Note that the allowance is not apportioned even when the asset is only used for part of the tax year or brought into use during the tax year. You will note that the depreciation of R6 000 is added back to the net profit and that the section 12E allowance of R13 500 is deducted for tax purposes. Depreciation is calculated for accounting purposes, while the section 12E allowance is deductible for tax purposes. For this reason the depreciation has to be added back to cancel its effect on net profit.

General wear and tear allowance – section 11 (e)
All other movable assets other than those that qualify for section 12C or 12E allowances (as above) can still qualify for a wear-and-tear allowance in terms of the general wear-and-tear provisions contained in section 11(e). BGR 7 forms the basis of the application of section 11(e), and also contains the acceptable write-off periods, in years, for a wide range of capital assets.

We do not expect you to memorise BGR 7 and will always give you an extract in a question. You should be able to determine the wear-and-tear allowance in respect of a specific asset that can be claimed for a specific year of assessment using the write-off periods as set out in BGR 7. The allowance is calculated pro rata for the period the asset was in use during the year of assessment – thus it is only allowed as a deduction for the number of months that the asset was used during the year of assessment.

5.3.1. Text Book
Note the apportionment of the allowance when the asset is only used for part of the tax year or brought into use during the tax year. When moving costs are incurred on an asset subject to wear and tear, the moving cost will form part of the cost of the asset and will be written off over the remainder of the write-off period of the asset. In the second example, moving costs of R10 000 were incurred on 1 January for a main-frame computer purchased in July of the previous year. Thus, from the date the moving cost was incurred, only 30 months remained to write-off the computer. Therefore the wear and tear to be claimed regarding the moving costs will be 12/30 x R10 000 = R4 000.

Please note that, if the taxpayer is registered for VAT purposes and was entitled to claim an input tax credit on the purchase price of the qualifying asset, such VAT should be excluded from the cost of that asset. Also note that wear-and-tear allowances apply to movable assets and do not apply to structures and works of a permanent nature such as buildings.
BUILDING ALLOWANCES
In addition to the plant, machinery and equipment (movable assets) that are used directly in a manufacturing process, the buildings used in a manufacturing process can also qualify for a capital allowance. Furthermore, buildings (commercial or residential) in predetermined urban areas may in certain circumstances qualify for specific allowances. There is also an allowance for commercial buildings. These provisions are set out in section 13 of the Act.

Buildings used in a process of manufacture – section 13(1)
The cost (excluding the cost of the land, but may include capitalised finance costs) of erecting or purchasing a manufacturing building by a taxpayer may qualify for an annual allowance of 5% provided it was erected on/after 1 October 1999 and is used “wholly or mainly” (more than 50%) for carrying on of a process of manufacturing.
This allowance is also claimable for improvements made by the taxpayer to the existing manufacturing building. Furthermore, note that a lessee who erects leasehold improvements on leased premises in terms of the lease agreement is entitled to a section 13 capital allowance in respect of the portion of the cost that does not qualify as a deduction in terms of section 11(g) (leasehold improvements).

Section 5.6.1 textbook
Note that the allowance is not apportioned even when the asset is only used for part of the tax year or brought into use during the tax year.

Commercial buildings – section 13quin
Section 13quin was introduced on 1 April 2007 and applies only to new or unused commercial buildings owned by the taxpayer, or improvements to existing buildings contracted for on or after 1 April 2007, and the construction of which only commenced on or after that date. It does not apply to residential buildings or to commercial buildings erected before 1 April 2007.
The allowance is 5% per annum, straight line, based on the cost of the building or improvements. Where the building is brought into use during the tax year, the allowance is not apportioned. The
building should be used wholly or mainly by the taxpayer during the year of assessment for the purposes of producing income in the course of the taxpayer’s trade.

Please note that when part of a building was acquired by a taxpayer on/after 21 October 2008 without the taxpayer erecting or constructing it, then the cost must be adjusted as follows:

- 55% of the acquisition cost price if only a part is acquired, and
- 30% of the cost of improvement, if an improvement is made.

### Section 5.6.2: Textbook

Note that the allowance is not apportioned even when the asset is only used for part of the tax year or brought into use during the tax year.

The section clearly states that no deduction will be allowed if another deduction can be claimed. Thus, this allowance can only be claimed if the building is owned by the taxpayer and on buildings that are new or unused.

**Residential units (s13sex) and the sale of low-cost residential units on a loan account (s13sept)**

A residential unit is defined as a building or self-contained apartment mainly used for residential accommodation but excluding buildings or apartments used in carrying on a trade as a hotel keeper.

The following example will explain the application of section 13sept and the recoupment when a repayment is made by an employee on his outstanding loan account with regard to the purchase of a low-cost residential unit:

On 1 October 2013, Big (Pty) Ltd commenced with the erection of a low-cost residential unit and a total cost of R180 000 was incurred in this regard. The unit was sold on 1 March 2014 to an employee for R180 000 on an interest-free loan account from Big (Pty) Ltd. The employee will make the following repayments:

- R20 000 on 10 April 2015
- R32 000 on 15 April 2016
- no repayment in 2017

Calculate the section 13sept allowances and recoupments on the residential unit for Big (Pty) Ltd for the years of assessment ending 30 April 2014 to 30 April 2017.
Urban development zones – section 13quat

Businesses are given an incentive to relocate to decayed urban areas and, as a result, existing infrastructure (i.e. public transport systems) is better utilised.

- On 30 June 2013, Easy (Pty) Ltd completed the erection of a new building in an urban development zone at a total cost of R5 000 000 and brought it into use immediately. Calculate the section 13quat allowance for the years of assessment ended 28 February 2014 and 28 February 2015.

Solution:
2014: R5 000 000 x 20% = R1 000 000
2015: R5 000 000 x 8% = R400 000

DISPOSAL OF ASSETS THAT WERE SUBJECT TO AN ALLOWANCE

During the carrying on of a business, a taxpayer may decide to sell or stop using an asset on which a capital allowance was previously claimed. Such assets could also have been damaged beyond repair. These events have tax implications as they could result in a recoupment or a s11(o) scrapping allowance. A recoupment is a recovery of the allowances previously claimed. Note that if an asset is sold for an amount that exceeds the original cost, a taxable capital gain may arise. This taxable capital gain is calculated in accordance with the provisions of the Eighth Schedule to the Act.

Scraping allowance – section 11(o)

A scraping allowance occurs when the cost of an asset exceeds the sum of the tax allowances or deductions in respect of that asset and the proceeds on disposal. This means that a loss has been made. The cost of the asset less the sum of the capital allowances is called the tax value of the asset. Thus, if the proceeds (selling price of the asset) are less than the tax value of the asset, the net result is a loss and the taxpayer may claim the loss as a scraping allowance provided that the asset was subject to a section 11(e), 12C or 12E allowance. When an asset is disposed of, the capital allowances

<table>
<thead>
<tr>
<th>Year of assessment ended 30 April 2014</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 13quat allowance (R180 000 x 10%)</td>
<td>(18 000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year of assessment ended 30 April 2015</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 13quat allowance (R180 000 – R20 000 repaid) x 10%</td>
<td>(16 000)</td>
</tr>
<tr>
<td>Recoupment of the repayment: the repayment of R20 000 limited to all deductions allowed less recoupments = R34 000 (R18 000 + R16 000 – R0)</td>
<td></td>
</tr>
<tr>
<td>Thus, the full repayment made is recouped</td>
<td>20 000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year of assessment ended 30 April 2016</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 13quat allowance (R180 000 – (R20 000 + R32 000)) x 10%</td>
<td>(12 800)</td>
</tr>
<tr>
<td>Recoupment of the repayment: the repayment of R32 000 limited to all deductions allowed less recoupments = R26 800 (R18 000 + R16 000 + R12 800 – R20 000)</td>
<td></td>
</tr>
<tr>
<td>Thus, an amount of R26 800 is recouped</td>
<td>26 800</td>
</tr>
<tr>
<td>(The balance of the repayment of R5 200 (R32 000 – R26 800) is carried forward to the 2016 year of assessment for a possible recoupment.)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year of assessment ended 30 April 2017</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 13quat allowance (R180 000 – (R20 000 + R32 000)) x 10%</td>
<td>(12 800)</td>
</tr>
<tr>
<td>Recoupment of the repayment: the repayment of R5 200 (balance brought forward from 2015) limited to all deductions allowed less recoupments = R12 800 (R18 000 + R16 000 + R12 800 + R12 800 – R20 000 – R26 800)</td>
<td></td>
</tr>
<tr>
<td>Thus, the repayment of R5 200 is recouped</td>
<td>5 200</td>
</tr>
</tbody>
</table>
that have been deducted each year need to be considered. We do this by calculating a tax value – see the diagram below.

Recoupmments – section 8(4)(a)
If an asset is sold for an amount exceeding (more than) the tax value (original cost price less allowances), the net result represents a recoupment of the taxable allowances previously claimed. The recoupment (limited to allowances previously claimed) should be included in gross income. 5.7.2 of the textbook

Deferral of recoupment of building allowances – section 13(3)
No building will qualify for a section 11(o) scrapping allowance. However if a taxpayer uses the proceeds from the disposal of building A to, for example, purchase a new building B, the taxpayer has the option to set off any recoupment from the disposal of building A against the cost of the new building B, instead of including the recoupment in taxable income. The net result would be that the future capital allowances on the new building B will be calculated on the reduced amount (cost of building B less the amount of the recoupment from building A over the life of building B). The new building B must be purchased or erected within 12 months from the date of disposal of building A and must qualify for the annual building allowance of 5%.

CONNECTED PERSONS AND LIMITATIONS OF ALLOWANCES
When a taxpayer purchases a depreciable asset (being an asset in terms of which a deduction or allowance, based on the cost or value of an asset, can be claimed) from a connected person, held by the connected person at any time during the period of two years before a taxpayer acquires it, section 23J will limit the capital allowances to the allowances the connected seller would have been able to claim plus the taxable capital gain the seller has to include in his taxable income as a result of the sale.

In scenario (a), company B purchases the machine for less than the tax value and the 20% allowance is calculated on the amount paid for the machine. In scenario (b) company B paid more than the tax value for the machine, but less than its original purchase price. In this scenario, the 20% allowance will also be calculated on the actual amount paid for the machine. In scenario (c), company B paid more than the original cost price for the machine. Company A, the seller, made a capital gain of R20 000 on the disposal of the machine to company B. The cost price of the machine is limited to the
original cost price of R100 000 plus the taxable portion of the capital gain of R20 000, thus R100 000 + R13 320 (R20 000 x 66.6%). The 20% allowance in scenario (c) is therefore calculated on R113 320.

Read the conclusion (section 5.9).

LEASED ASSETS
taxpayer can decide to rent the assets (or some of them) which are needed for his or her business activities, rather than to purchase them. If this is the case the taxpayer will be the lessee. There are three main types of expense which relate to leased assets:
- rent paid (normally deductible according to the general deduction formula s 11(a))
- lease premium (deductible in accordance with s 11(f))
- leasehold improvements (deductible in accordance with s 11(g))

Lease premium and leasehold improvements will be dealt with in TAX3701 and need not be studied for the purpose of this course.

Complete the following table regarding the capital allowances applicable to assets qualifying for wear-and-tear allowances.

<table>
<thead>
<tr>
<th>Section 12E</th>
<th>Section 12C</th>
<th>Section 11(e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Which taxpayers can make use of this section?</td>
<td>Small business corporations</td>
<td>Manufacturers or similar processes</td>
</tr>
<tr>
<td>For which assets can each of these sections be applied?</td>
<td>Manufacturing plant and machinery or any non-manufacturing assets</td>
<td>Assets used in a process of manufacture or a similar process</td>
</tr>
<tr>
<td>At what rate is the allowance applied?</td>
<td>100% for manufacturing plant and machinery and 50%/30%/20% for all other assets</td>
<td>New: 40%/20%/20%/20% Used: 20% per annum for five years</td>
</tr>
</tbody>
</table>

SELF-ASSESSMENT QUESTIONS

QUESTION 6.1 (28 marks, 34 minutes)
Sunshine Traders CC manufactures animal feed and supplies farming utilities to local farmers. Sales occur on a cash and credit basis. The CC is a small business corporation as defined. All amounts exclude VAT, unless otherwise indicated. Sunshine Traders CC is registered on the invoice basis for VAT. The following information is supplied to you in respect of the year of assessment ending 28 February 2014:
<table>
<thead>
<tr>
<th>Income</th>
<th>Notes</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales – cash and credit</td>
<td></td>
<td>3 000 000</td>
</tr>
<tr>
<td>Interest accrued i.r.o. credit sales to farmers</td>
<td></td>
<td>800 000</td>
</tr>
<tr>
<td>Proceeds from sale of patent</td>
<td>1</td>
<td>150 000</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td>2</td>
<td>2 000 000</td>
</tr>
<tr>
<td>Bad debts</td>
<td></td>
<td>100 000</td>
</tr>
<tr>
<td>Doubtful debts</td>
<td>3</td>
<td>300 000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>4</td>
<td>1 120 000</td>
</tr>
<tr>
<td>Repairs</td>
<td>5</td>
<td>75 000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>6</td>
<td>140 000</td>
</tr>
</tbody>
</table>

**Notes:**

1. **Patent**

   On 1 March 2012, Sunshine Traders CC acquired a patent at a cost of R120 000 which was used in the production of income. The expected useful life of the patent was 10 years at 1 March 2012. On 28 February 2014 the patent was sold for R150 000. A taxable capital gain of R19 980 resulted from this transaction.

2. **Cost of sales**

   Cost of sales comprises the following:

<table>
<thead>
<tr>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock on hand at 28 February 2013 at market value</td>
</tr>
<tr>
<td>Purchases</td>
</tr>
<tr>
<td>Stock on hand at 28 February 2014 at cost price</td>
</tr>
<tr>
<td>(750 000)</td>
</tr>
<tr>
<td>Cost of sales</td>
</tr>
</tbody>
</table>

   The cost price of stock on hand at 28 February 2013 was R725 000. The market value of stock on hand at 28 February 2014 was R775 000.
3. **Outstanding debtors and doubtful debts**

The doubtful debt allowance for the year of assessment ended 28 February 2013 was R50 000. The list of doubtful debtors on 28 February 2014 amounts to R300 000 (including finance charges accrued of R60 000). SARS grants 25% of the doubtful debts as an allowance for taxation purposes. The outstanding debtors balance on 28 February 2014 was R750 000 (excluding finance charges).

4. **Salaries and wages**

Salaries and wages comprise the following: R

- Salaries and wages (approved by the Commissioner) 1 000 000
- Employer contributions to the provident fund 105 000
- Annuities paid to dependants of three deceased former employees 15 000

**Total:** 1 120 000

5. **Repairs**

The unpaved parking lot for approximately 40 vehicles washed away after a cloudburst. The parking lot was repaired and paved with bricks at a cost of R50 000. Additional parking space for approximately 15 additional vehicles was provided simultaneously at a cost of R25 000.

6. **Depreciation**

- **6.1** Office equipment purchased on 1 September 2011, with a cost price of R125 000 and a tax value of R25 000 on 1 March 2013, is still in use.
- **6.2** New machinery with a cost price of R330 000 was purchased on 1 July 2013.
- **6.3** Office furniture with a cost price of R100 000, purchased on 1 May 2011, was no longer suitable to the business, and was scrapped on 1 April 2013.

**Required**

Calculate the **tax payable** by Sunshine Traders CC for the year of assessment ended 28 February 2014.

**Solution**

**QUESTION 5.1**

**Calculation of the tax payable by Sunshine Traders CC for the year of assessment ended 28 February 2014**

<table>
<thead>
<tr>
<th>Description</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>3 000 000 (1)</td>
</tr>
<tr>
<td>Sales – cash and credit</td>
<td>800 000 (1)</td>
</tr>
<tr>
<td>Interest accrued from farmers</td>
<td></td>
</tr>
<tr>
<td>Patent sold – cost price</td>
<td>120 000</td>
</tr>
<tr>
<td>Allowances 2013–2014 (R120 000 x 5% x 2 yrs)</td>
<td>(12 000) (2)</td>
</tr>
<tr>
<td>Tax value</td>
<td>108 000</td>
</tr>
<tr>
<td>Proceeds</td>
<td>(150 000) (1)</td>
</tr>
<tr>
<td>Recoupment</td>
<td>(42 000)</td>
</tr>
<tr>
<td>Recoupment limited to previous allowances claimed</td>
<td>12 000 (1)</td>
</tr>
</tbody>
</table>
Once you have worked through study unit 7, you will see that you should be able to calculate the taxable capital gain of R19 980 that was given in this question. It is calculated as follows:

Proceeds less base cost = Gain x 66.6% inclusion rate = Taxable capital gain

Proceeds: (R150 000 - R12 000) = R138 000
Less: Base cost: (R120 000 - R12 000) = (R108 000)
Gives: Gain = R30 000
x 66.6% inclusion rate = R19 980 (figure given)

If a taxpayer meets the requirements, in addition to a doubtful debts allowance (25% of the total list of doubtful debts), they can claim a debtors allowance in terms of section 24. This is based on the outstanding debtors balance at year end (excluding finance charges) x the GP percentage of the entity. Remember you must deduct the doubtful debts allowance that you have claimed (excluding finance charges) from the debtors balance first. Also remember you cannot create a loss or increase a loss with this deduction; it is limited to the income.
STUDY UNIT 7 - Capital Gains Tax (CGT)

if a taxpayer receives or accrues a gain of a capital nature, the amount will still not meet the requirements of the gross income definition, but the amount will now be taxed and be subject to CGT. Therefore, gains received by or accrued to a taxpayer are always taxed; either through the inclusion in gross income if they are of a revenue nature or through CGT if they are of a capital nature.

Watch the vodcast “Introduction to capital gains tax”,

when an asset is disposed of, you must determine whether the gain is of a revenue nature or of a capital nature.

There are several transactions that are regarded as deemed disposals for CGT purposes. This means that, although a transaction is not an actual disposal as described in section 6.5 of the textbook, where the asset is deemed to be disposed of at market value and immediately reacquired at expenditure equal to that market value the Act regards it as a disposal. For the purposes of this module, you need to be able to identify the following deemed disposals:

When doing a practical case study, you must be able to identify cases where a deemed disposal is applicable and then include it correctly in your calculation.

The time of disposal is important as it will determine in which year of assessment the taxpayer has to include the capital gain in his taxable income calculation. The time of disposal depends on the type of disposal (e.g. sale of agreement with or without a condition, distribution of an asset, donation, etc).

You must be able to determine whether a transaction in a question is a disposal or a deemed disposal and whether it is one of the events that are specifically a non-disposal, meaning that no CGT should be calculated. You must also be able to say whether the capital gain must be calculated for the current year of assessment, the previous year of assessment or the following year of assessment.

BASIC FRAMEWORK AND CGT RATES

<table>
<thead>
<tr>
<th></th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds (i.e. the selling price adjusted for CGT purposes)</td>
<td>XX</td>
</tr>
<tr>
<td>Less: Base cost (i.e. the cost price adjusted for CGT purposes)</td>
<td>(XX)</td>
</tr>
<tr>
<td>Capital gain/(loss)</td>
<td>XX</td>
</tr>
</tbody>
</table>

After the gain/loss has been determined for each asset individually, you need to determine whether there is any total or partial exclusion that can be applied. Thereafter, you add all the capital gains and/or losses together, bring in the capital loss of the previous year and apply the inclusion rate.

Framework for calculating the taxable capital gain:
PROCEEDS
Adjusted proceeds (for CGT purposes) = selling price minus recoupment

Because the recoupment is added to income for income tax purposes, it is deducted (or not taken into account) for CGT purposes.

The tax value of an asset is the cost price less all capital allowances (e.g. wear and tear) that have been claimed during the years that the asset was in use. Remember, the recoupment is limited to the allowances previously claimed. Let’s look at an example.
An asset is disposed of and the following is applicable:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price on date of disposal</td>
<td>R120</td>
</tr>
<tr>
<td>Cost of asset</td>
<td>R100</td>
</tr>
<tr>
<td>Transfer duty paid on purchase</td>
<td>R 10</td>
</tr>
<tr>
<td>All allowances claimed in previous years</td>
<td>R 70</td>
</tr>
</tbody>
</table>

The first step is to calculate the **tax value** on the date of disposal:

\[
\text{Cost of asset} - \text{Less: All allowances claimed} = \text{Tax value}
\]

\[
\begin{align*}
\text{Cost of asset} & = \text{R100} \\
\text{Less: All allowances claimed} & = \text{R 70} \\
\text{Tax value} & = \text{R 30}
\end{align*}
\]

The second step is to calculate the **recoupment**:

\[
\text{Selling price} - \text{Less: Tax value (as calculated above)} = \text{Profit}
\]

\[
\begin{align*}
\text{Selling price} & = \text{R120} \\
\text{Less: Tax value (as calculated above)} & = \text{R 30} \\
\text{Profit} & = \text{R 90}
\end{align*}
\]

However, this amount is **limited** to all the allowances previously claimed, that is, R70. Therefore, the recoupment is R70 and not R90.

The last step is to calculate the **adjusted proceeds**:

\[
\text{Selling price} - \text{Less: Recoupment} = \text{Adjusted proceeds}
\]

\[
\begin{align*}
\text{Selling price} & = \text{R120} \\
\text{Less: Recoupment} & = \text{R 70} \\
\text{Adjusted proceeds} & = \text{R 50}
\end{align*}
\]

Therefore, the adjusted proceeds that must be used in calculating CGT are R50.

You need to memorise the above process in order to calculate the proceeds for CGT purposes. When you are given a question on CGT in the examination, you will be provided with the amount of all capital allowances claimed previously, so you will not have to calculate this amount.

**BASE COST**

The base cost is an important element of the CGT calculation: the higher the base cost the less the tax that may be payable. Therefore, it is important to know which costs must be included or excluded from the base cost.

**Included in the base cost**

It is obvious that the acquisition cost (purchase price) of an asset will form part of the base cost, but there are also several other costs, such as improvements to a property, agent’s commission, valuation costs, and so on, that also form part of the base cost.

Study section 6.7.1 of the textbook and make a summary for yourself of which costs can form part of the base cost and which cannot.

**Excluded from the base cost**

In the previous section it was explained that proceeds are not always equal to the actual selling price. Similarly, the base cost is not just the cost price alone but rather the adjusted cost price. When calculating the base cost of an asset, it is important to remember that capital allowances must be deducted from the base cost of the asset. As mentioned before: when calculating CGT in a question, you will be provided with the amount of all...
capital allowances claimed previously, so you need not calculate this amount in any question for the purposes of this module. Also note that any other expenditure relating to this asset (e.g. repairs, maintenance and interest), which have been deducted from the taxpayer’s taxable income in the past and current years of assessment, may not form part of the base cost.

**EXAMPLE: costs included in/excluded from base cost**

Flowers (Pty) Ltd purchased an office building on 12 September 2006 and subsequently sold it on 30 November 2013 for R500 000.

All the costs incurred on this building are as follows:

<table>
<thead>
<tr>
<th>Cost Description</th>
<th>Amount (R)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price (cost price)</td>
<td>895 000</td>
</tr>
<tr>
<td>Transfer duty and legal costs relating to the purchase of the asset</td>
<td>52 000</td>
</tr>
<tr>
<td>Valuation costs</td>
<td>8 000</td>
</tr>
<tr>
<td>Legal and contract costs relating to the sale of the asset</td>
<td>5 000</td>
</tr>
<tr>
<td>Interest paid on the loan to finance the building</td>
<td>200 000</td>
</tr>
<tr>
<td>Repairs and maintenance</td>
<td>48 000</td>
</tr>
</tbody>
</table>

The building was used in the production of income and any allowable expenses were claimed for income tax purposes. No capital allowances were claimable owing to the fact that the office building (commercial building) was purchased before 2007 when the commercial building allowance was introduced – see study unit 6.

**Required:**
Calculate the base cost of the office building.

<table>
<thead>
<tr>
<th>Solution:</th>
<th>Amount (R)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price</td>
<td>895 000</td>
</tr>
<tr>
<td>Transfer duty and legal costs</td>
<td>52 000</td>
</tr>
<tr>
<td>Valuation costs</td>
<td>8 000</td>
</tr>
<tr>
<td>Legal and contract costs</td>
<td>5 000</td>
</tr>
<tr>
<td>Interest paid (R200 000) (note)</td>
<td>-</td>
</tr>
<tr>
<td>Repairs (R48 000) (note)</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>960 000</strong></td>
</tr>
</tbody>
</table>

**Note:**
Interest paid and repairs were claimed for income tax purposes and are therefore not added to the base cost for CGT purposes.
The base cost formula for assets acquired after 1 October 2001 is very straightforward:

\[
\text{Base cost} = \text{Cost of asset (all allowable costs)} - \text{All allowances claimed previously}
\]

**section 7.4 example**

Cost of asset \( R100 \)
Plus: Transfer duty \( R10 \)
Less: All allowances claimed previously \( R70 \)
Base cost \( R40 \)

To test whether you understand the principles explained above, answer the following question:

**QUESTION 7.1**

Rings and Things (Pty) Ltd manufactures jewellery. Its year of assessment ends on 31 March 2013. A manufacturing machine of the company was destroyed in a fire on 31 January 2013. The machine was originally purchased second hand on 31 May 2011 for R500 000 and was brought into use on the same date in a process of manufacture. The destroyed machine was sold to a scrap dealer on 15 February 2013 for R15 000. Rings and Things (Pty) Ltd paid advertising costs of R1 000 to advertise the scrap (destroyed machine) for sale in several newspapers. An indemnity payment of R600 000 was received on 31 March 2013 from Rings and Things (Pty) Ltd’s insurance company.

**Required:**

Calculate the taxable capital gain/loss for the 2013 year of assessment.
**Assets acquired before 1 October 2001**

The base cost formula for assets acquired before 1 October 2001 is totally different to the one explained above, and is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valuation date value</td>
<td>XXX</td>
</tr>
<tr>
<td>Plus: Allowable costs incurred on or after 1 October 2001</td>
<td>(XXX)</td>
</tr>
<tr>
<td>Base cost</td>
<td>XXX</td>
</tr>
</tbody>
</table>

The valuation date value is the value of the asset on 1 October 2001. This takes into account all the costs of the asset plus the increase in the value of the asset up to 30 September 2001. The valuation date value amount is "deemed" to be the cost price of the asset as if you had acquired it on 1 October 2001.

The valuation date value is determined by paragraph 26 and paragraph 27 of the Eighth Schedule of the Act. Paragraph 26 is applicable when the adjusted proceeds are **more** than the adjusted cost of an asset (in other words a profit), and paragraph 27 is applicable when the adjusted proceeds are **less** than the adjusted cost of an asset (in other words a loss). These paragraphs contain provisions that serve as anti-avoidance measures, owing to the fact that a taxpayer can manipulate the market value of the asset to ensure that a capital loss is realised on disposal of the asset. For the purposes of this module only paragraph 26 will be dealt with. Paragraph 27 will be explained in the module TAX3701.
Before you start with the valuation date value calculation, divide all allowable costs between pre (before) 1/10/2001 and post (after) 1/10/2001. Remember to deduct capital allowances (if applicable). The next step is to identify the following three values:

- **Market value**: In an exam question, you will be given the market value.
- **20% rule**: Calculate this value as follows: 20% x (adjusted proceeds less allowable costs [as calculated] incurred on or after 1 October 2001)
- **Time-apportionment base cost (TAB-cost)**: For the purposes of this module, we will not expect you to be able to calculate the time-apportionment base cost. In an exam question, you will be given the value – you just need to know where to use it.

The final step in determining the valuation date value is to apply the rules of paragraph 26 and select the valuation date value (to be used in the base cost calculation).

Did you see that if the market value is the highest of the three values, then there is an additional step that you must follow in determining the valuation date value?

following is a summary of paragraph 26 and how it is applied:

| 26.1 If proceeds (as adjusted) > total base cost (as calculated), then valuation date value is the higher of:  |
|---|---|
| (a) market value, or |
| (b) 20% rule, or |
| (c) TAB-cost |

26.2 If the pre-1/10/2001 portion of base cost cannot be determined, the valuation date value is the higher of:

- (a) market value, or
- (b) 20% rule

26.3 If the market value is adopted as the valuation date value in 26.1 above, and proceeds (adjusted) < market value, then the valuation date value = proceeds (adjusted) less allowable costs incurred on or after 1 October 2001. If proceeds (adjusted) > market value, then valuation date value remains the market value.

After you have determined the valuation date value by applying the rules of paragraph 26, do not forget to add the allowable costs incurred after 1/10/2001 to calculate the base cost amount.

The following question and solution are a good example of how to apply paragraph 26.

**QUESTION 7.2**
Go-Go (Pty) Ltd purchased an office building on 1 August 1982 at a cost price of R1 235 000. No capital allowances were claimable on this building. Transfer duty and transfer costs amounted to R133 500.

During November 2006, extensive improvements were effected to the building amounting to R832 000. The company sold the building on 15 December 2013 for R12 500 000. The time apportionment base cost is R5 539 026. Go-Go also paid agent’s commission to the amount of R67 500 when the building was sold.

**Required:**
Calculate the taxable capital gain or capital loss that Go-Go (Pty) Ltd realised in selling the building for the year of assessment ended 31 March 2014, if the market value of the building on 1 October 2001 amounted to:
(a) R12 000 000, or
(b) R14 000 000.

**QUESTION 7.2**

**PART (a)**

1. **Calculation of proceeds for capital gains tax purposes**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>12 500 000 (1)</td>
</tr>
<tr>
<td>Less: Recoupment (no allowances claimed, thus no recoupment)</td>
<td>nil (1)</td>
</tr>
<tr>
<td><strong>Proceeds for capital gains tax</strong></td>
<td>12 500 000</td>
</tr>
</tbody>
</table>

2. **Calculation of base cost**

   Calculate total cost and divide between before 1/10/2001 and after 1/10/2001.

   **2.1 Divide cost between cost incurred on or before 1/10/2001 and after 1/10/2001:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Before 1/10/2001</th>
<th>After 1/10/2001</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost price</td>
<td>12 350 000</td>
<td>12 350 000</td>
<td></td>
</tr>
<tr>
<td>Add: Transfer duty and transfer cost</td>
<td>133 500</td>
<td>133 500</td>
<td></td>
</tr>
<tr>
<td>Agent commission</td>
<td>67 500</td>
<td>67 500</td>
<td></td>
</tr>
<tr>
<td>Nov 2006 improvements</td>
<td>832 000</td>
<td>832 000</td>
<td></td>
</tr>
<tr>
<td><strong>Cost for CGT purposes</strong></td>
<td>1 368 500</td>
<td>899 500</td>
<td>2 268 000</td>
</tr>
</tbody>
</table>

   **2.2 Calculate the valuation date value**

   Since the proceeds (R12 500 000) exceeds the total cost (R2 268 000), paragraph 26 applies and the following options can be considered:

   - Market value on 1/10/2001 = R12 000 000 (given) (1)
   - 20% x (proceeds - cost incurred after valuation date) = 20% x (R12 500 000 - R899 500) = R2 320 100 (3)
   - Time apportionment base cost = R5 539 026 (given) (1)

   Valuation date value = the greatest of the above 3 options, therefore R12 000 000 (1)

   Market value may be used, since the proceeds exceeds the market value (par. 26(3)) (1)

   **2.3 Calculate the base cost**

   Base cost = Valuation date value **plus** costs incurred after 1/10/2001
   = R12 000 000 + R899 500
   = R12 899 500

   **3. Calculation of the capital gain/loss**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds (calculation 1)</td>
<td>12 500 000 (1)</td>
</tr>
<tr>
<td>Less: Base cost (calculation 2)</td>
<td>(12 899 500) (1)</td>
</tr>
<tr>
<td><strong>Capital loss</strong></td>
<td>(399 500)</td>
</tr>
</tbody>
</table>

67
CAPITAL GAIN AND CAPITAL LOSS

Now that you know how to determine the proceeds and base cost for CGT purposes, the next step is to deduct the base cost from the proceeds to determine the capital gain or loss on the disposal of an asset. If the proceeds are more than the base cost, then there will be a capital gain. If the proceeds are less than the base cost, then there will be a capital loss. After the exclusions (discussed in the next section) have been taken into account, the capital gains and losses of all assets disposed during the year of assessment are added together (i.e. the aggregate capital gain/(loss) – refer to the CGT framework in section 7.3 above). The assessed capital loss brought forward from the previous year of assessment is deducted from this amount to calculate the net capital gain/(loss).
If this calculated amount is a net capital gain, it is then multiplied by the inclusion rate of 66.6% to calculate the **taxable capital gain**. However, if it is a net capital loss, then this amount is called an **assessed capital loss** and your calculation is complete (i.e. the loss is not multiplied by the inclusion rate of 66.6%). An assessed capital loss is carried forward to the next year of assessment and will be taken into account in the CGT calculation for that year. An assessed capital loss can-not be set off against other taxable income.

It is important to know the terms explained above, and to be able to distinguish between them. When doing a CGT calculation, you must use the correct term in the correct place in the CGT framework. The following question and solution (at the back of the study guide) demonstrate the difference between the above terms. Attempt to do the question on your own first, before looking at the solution at the back of the study guide.

**QUESTION 7.3**

Banana (Pty) Limited is a manufacturer of soccer balls and its year-end is 31 March 2014.

On 1 April 2012, Banana (Pty) Ltd bought land and a factory building at a cost of R1 370 000. According to the contract the original purchase price was made up as follows:

- Cost of land: R450 000
- Factory building: R920 000

Owing to a cash flow problem, the company was forced to sell the land and factory building on 30 October 2013. The selling price was R3 825 000 and was arrived at as follows:

- Land: R1 175 000
- Factory building: R2 650 000

The total capital allowances claimed on the factory building was R92 000.

**Required:**

Calculate the taxable capital gain or capital loss for the year ended 31 March 2014. Banana (Pty) Ltd has an assessed **capital loss** of R55 000 brought forward from the previous year of assessment.

**Solution**
EXCLUSIONS PER ASSET
The Act provides that, in certain situations, the gain that is made on the disposal of, or a part of the gain that is made on, specific assets will not be taxable. These rules are referred to as exclusions. For the purpose of this module we expect you to know the following exclusions:

- donations and bequests to the government or any provincial administration
- donations and bequests to public benefit organisations
- donations and bequests to a recreational club
QUESTION 7.4 (20 marks, 24 minutes)
During the year ended 30 April 2014, Digital Systems (Pty) Ltd entered into the following transaction:
A factory building in Durban was sold on 30 November 2013 for R4 750 000. The building was acquired on 1 December 2000 for R1 500 000. Additions to the building to the value of R275 500 were made during June 2009. Valuation costs of R10 500 were paid to a sworn appraiser who determined the market value of the building to be R2 025 000 as at 1 October 2001. The time apportionment base cost on 1 October 2001 is R2 613 000. The total capital allowances claimed were R900 000 on the factory building and R55 100 on the additions to the factory building.

REQUIRED:  
Calculate the taxable capital gain or loss for the year of assessment ended 30 April 2014.  

Hint: First calculate the tax value of the building and the tax value of the additions to the building separately, and then add them together to obtain the total tax value. Remember that the selling price relates to the building as well as the additions (which are sold altogether).
**QUESTION 7.4**

<table>
<thead>
<tr>
<th>Building – before 1 October 2001</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost price</td>
<td>1 500 000</td>
</tr>
<tr>
<td>Less: Capital allowances claimed</td>
<td>(900 000)</td>
</tr>
<tr>
<td>Tax value</td>
<td>600 000 (1)</td>
</tr>
</tbody>
</table>

**Additions – after 1 October 2001**

| Cost price | 275 500 |
| Less: Capital allowances claimed | (55 100) |
| Tax value | 220 400 (1) |

**Recoupment**

| Selling price | 4 750 000 (1) |
| Less: Tax value (R600 000 + R220 400) | (820 400) (2) |
| Recoupment | 3 929 600 |
| Limited to previous allowances (R900 000 + R55 100) | 955 100 (1) |

**Proceeds**

| Less: recoupment | (955 100) (1) |
| Adjusted proceeds | 3 794 900 (1) |

**Paragraph 26 applicable because proceeds (R3 794 900) > total expenditure (R830 900) (1)**

You may use the greatest of the following:

1. **Market value as at 1 October 2001**
   - Total cost - factory building | 600 000 |
   - Add: total cost – additions | 220 400 |
   - Valuation costs | 10 500 |
   - **Cost for CGT purposes** | 830 900 |

2. **Time Apportionment base cost (TAB)**
   - Total cost - factory building | 600 000 |
   - Add: total cost – additions | 220 400 |
   - Valuation costs | 10 500 |
   - **Cost for CGT purposes** | 830 900 |

**Base cost** = VDV + cost after 1 October 2001

- **Tab is the highest, valuation date value (VDV) is therefore R2 613 000. (1)**

**TAXABLE CAPITAL GAIN**

Proceeds (adjusted) | 3 794 900 (1) |
Less: Base cost (calculated above) | (2 843 900) (1) |
**Capital gain** | 951 000 |
**Taxable gain at the inclusion rate of 66.6%** | 633 366 (1) |

**QUESTION 7.5 (24 marks, 29 minutes)**

Gelati (Pty) Ltd entered into the following transactions during the year of assessment ending 31 March 2014.

**TRANSACTION 1**

An office building in Cape Town was sold on 20 January 2014 for R3 500 000. The building had been acquired on 10 December 2000 for R3 200 000. Valuation costs of R3 000 were paid to a sworn appraiser who determined the market value of the building to be R3 000 000 as at 1 October 2001. The time apportionment base cost on 1 October 2001 is R3 112 207. The office building did not qualify for any tax allowances.
TRANSACTION 2
A factory building constructed by Gelati (Pty) Ltd was sold on 31 January 2014 for R7 000 000. Construction costs of the factory amounted to R5 000 000 and the factory was completed at the end of November 2012. The capital allowances claimed for this asset are R500 000.

REQUIRED: Calculate the aggregate taxable capital gain or loss for the year of assessment ending 31 March 2014. Assume that Gelati (Pty) Ltd has an assessed capital loss of R52 000 brought forward from the previous year.

MARKS 24

QUESTION 7.5

TRANSACTION 1

Pre 1 October 2001 costs = R3 200 000
Post 1 October 2001 costs = R3 000

Paragraph 26 applicable because proceeds (R3 500 000) > total expenditure (R3 203 000) (1)

Use the greatest of the following:
1. Market value as at 1 October 2001 = R3 000 000 (1)
2. Time Apportionment base cost (TAB) = R3 112 207 (1)
3. 20% x (proceeds - cost incurred after valuation date) =
   20% x (R3 500 000 - R3 000) = R699 400 (3)

TAB is the highest, valuation date value (VDV) is therefore R3 112 207. (1)

Determine the base cost:
Base cost = valuation date value plus costs incurred after 1 October 2001:
= R3 112 207 + R3 000 = R3 115 207 (2)

Calculate capital gain/loss:

<table>
<thead>
<tr>
<th>Proceeds</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 500 000</td>
<td>(1)</td>
</tr>
<tr>
<td>Less: Base cost</td>
<td>(3 115 207) (1)</td>
</tr>
<tr>
<td>Capital gain</td>
<td>384 793</td>
</tr>
</tbody>
</table>

TRANSACTION 2

<table>
<thead>
<tr>
<th>Cost</th>
<th>R 5 000 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Allowances claimed</td>
<td>(500 000)</td>
</tr>
<tr>
<td>Tax value</td>
<td>4 500 000 (1)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Selling price</th>
<th>R 7 000 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Tax value on date of sale</td>
<td>(4 500 000) (1)</td>
</tr>
<tr>
<td>Recoupment</td>
<td>2 500 000</td>
</tr>
</tbody>
</table>

Limited to previous allowances claimed:

<table>
<thead>
<tr>
<th></th>
<th>R 500 000</th>
</tr>
</thead>
</table>

Proceeds calculation:

<table>
<thead>
<tr>
<th>Proceeds</th>
<th>R 7 000 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Recoupment</td>
<td>(500 000) (1)</td>
</tr>
<tr>
<td>Adjusted proceeds for CGT</td>
<td>6 500 000 (1)</td>
</tr>
</tbody>
</table>
QUESTION 7.6 (19 marks, 23 minutes)

X Ltd concluded the following transactions during the year of assessment ended 31 March 2014:

1. A delivery vehicle purchased on 1 July 2012 for R180 000 was sold on 30 November 2013 for R100 000. X Ltd claimed allowances of R63 750 on this asset and also qualified for a section 11(o) scrapping allowance where applicable.

2. An office building was sold on 20 January 2014. The selling price amounted to R2 250 000. The office building was purchased on 10 December 2005 for R1 600 000.

Costs incurred in connection with the office building, for the period 10/12/2008 until 20/01/2014, amounted to R1 076 000 and consisted of the following:

<table>
<thead>
<tr>
<th></th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improvements</td>
<td>220 000</td>
</tr>
<tr>
<td>Transfer duty and transfer costs paid</td>
<td>236 000</td>
</tr>
<tr>
<td>Interest paid on mortgage bond</td>
<td>445 000</td>
</tr>
<tr>
<td>Property tax</td>
<td>175 000</td>
</tr>
<tr>
<td></td>
<td>1 076 000</td>
</tr>
</tbody>
</table>

Property tax and Interest paid on mortgage bond were allowed as deductions for income tax purposes. No capital allowances were claimed on this asset.

X Ltd’s assessed capital loss brought forward from the previous year of assessment amounted to R75 000.

REQUIRED:

Calculate X Ltd’s taxable capital gain or capital loss for the year of assessment ended 31 March 2014.
Question 7.6 - Delivery vehicle:

Calculation of the tax value

<table>
<thead>
<tr>
<th>Description</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost price</td>
<td>180 000</td>
</tr>
<tr>
<td>Less: Capital allowances claimed</td>
<td>(63 750)</td>
</tr>
<tr>
<td><strong>Tax value</strong></td>
<td><strong>116 250</strong></td>
</tr>
</tbody>
</table>

Calculation of s 11(o) scrapping allowance on delivery vehicle

<table>
<thead>
<tr>
<th>Description</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>100 000</td>
</tr>
<tr>
<td>Less: Tax value</td>
<td>(116 250)</td>
</tr>
<tr>
<td>S 11(o) scrapping allowance (claimed for income tax)</td>
<td>(16 250)</td>
</tr>
</tbody>
</table>

Calculation of proceeds

<table>
<thead>
<tr>
<th>Description</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>100 000</td>
</tr>
<tr>
<td>Less: Adjustments (no adjustments, as there is no recoupment)</td>
<td>nil</td>
</tr>
<tr>
<td><strong>Proceeds</strong></td>
<td><strong>100 000</strong></td>
</tr>
</tbody>
</table>

Calculation of base cost

<table>
<thead>
<tr>
<th>Description</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>180 000</td>
</tr>
<tr>
<td>Less: Capital allowances claimed</td>
<td>(63 750)</td>
</tr>
<tr>
<td>Less: S 11(o) scrapping allowance (refer lecturer's note)</td>
<td>(16 250)</td>
</tr>
<tr>
<td><strong>Base cost</strong></td>
<td><strong>100 000</strong></td>
</tr>
</tbody>
</table>

Calculation of capital gain

<table>
<thead>
<tr>
<th>Description</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>100 000</td>
</tr>
<tr>
<td>Less: Base cost</td>
<td>(100 000)</td>
</tr>
<tr>
<td><strong>Capital gain</strong></td>
<td><strong>nil</strong></td>
</tr>
</tbody>
</table>

The scrapping allowance is claimed for income tax purposes (refer to study unit 6 to refresh your memory), therefore this amount must be removed from the cost of the asset for the capital gains tax calculation.

Office building:

Calculation of base cost

<table>
<thead>
<tr>
<th>Description</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost price</td>
<td>1 600 000</td>
</tr>
<tr>
<td>Add: Improvements</td>
<td>220 000</td>
</tr>
<tr>
<td>Add: Transfer duty</td>
<td>236 000</td>
</tr>
<tr>
<td>Interest paid (claimed for income tax, not part of base cost)</td>
<td>nil</td>
</tr>
<tr>
<td>Property tax (claimed for income tax, not part of base cost)</td>
<td>nil</td>
</tr>
<tr>
<td><strong>Base cost</strong></td>
<td><strong>2 056 000</strong></td>
</tr>
</tbody>
</table>

Calculation of capital gain

<table>
<thead>
<tr>
<th>Description</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds (no capital allowances or recoupment, thus no adjustment)</td>
<td>2 250 000</td>
</tr>
<tr>
<td>Less: Base cost</td>
<td>(2 056 000)</td>
</tr>
<tr>
<td><strong>Capital gain</strong></td>
<td><strong>194 000</strong></td>
</tr>
</tbody>
</table>

Taxable capital gain:

<table>
<thead>
<tr>
<th>Description</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gain/loss on delivery vehicle</td>
<td><strong>nil</strong></td>
</tr>
<tr>
<td>Capital gain on office building</td>
<td><strong>194 000</strong></td>
</tr>
</tbody>
</table>
TAX2601 ASSIGNMENT 2 FOR 2014/01

QUESTION 1 (20 marks, 24 minutes)

You are a trainee accountant and a member of the audit team currently performing the audit of Betty Blue (Pty) Ltd (“Betty Blue”). Betty Blue manufactures lipsticks at its factory in the south of Johannesburg and distributes them locally. Betty Blue is a registered VAT vendor. The financial accountant at Betty Blue has almost completed the calculation of the taxable income for the year of assessment ending 31 December 2013. She is unsure how to handle some of the transactions that occurred during the year for taxation purposes and has asked that you complete the taxable income calculation taking these transactions into account.

The taxable income she arrived at was R2 356 000. Assume the calculation of this figure is correct (in terms of the provisions of the Income Tax Act).

The following are the transactions she is unsure of: (All amounts exclude VAT unless stated otherwise.)

1. **Insurance premiums**

   Insurance premiums of R245 000 were paid in full for the 12-month period from 1 August 2013 to 31 July 2014.
2. Trademark
On 30 June 2013 one of the lipstick trademarks Betty Blue had registered in 2011 was renewed for a further three years at a cost of R75 000.

3. Research and development
A dedicated team employed by Betty Blue was used in a highly scientific research and development project. The aim of the project was to develop a lipstick range that would colour lips for up to 16 hours without reapplying. The necessary approval from the Science and Technology Department was received on 30 September 2013. Salaries amounting to R640 440 in total were paid (R451 440 was paid on 30 July 2013 and R189 000 was paid on 28 November 2013) for the year of assessment.

4. Design
On 31 May 2013 Betty Blue purchased a specific design to be used for their lipstick winter range from Levron Cosmetics for R120 000.

5. Bad debts and doubtful debts allowance
R60 000 relates to only one bad debtor. Betty Blue has tried to collect the outstanding R60 000 since 2011 but finally decided to write off the amount in the 2013 year of assessment. A provision for doubtful debts of R123 000 in respect of doubtful debtors had been raised for the 2013 year of assessment. A doubtful debt allowance of R22 500 was allowed by SARS in 2012.

6. Penalties and interest
There is a penalty of R250 from submitting a VAT return one month late and some interest of R1 789 for outstanding skills development levies.

7. Salaries and wages
Salaries and wages amounting to R1 200 000 were not taken into account. Contributions to a pension fund of R110 000 made during the 2013 year have also not been dealt with by the accountant.

8. Sale of end range lipsticks
Forty lipsticks that were end of range were sold to staff for less than the market value during the stock take that took place on 30 December 2013. The lipsticks had a market value of R65 each and the staff members purchased them for R30 each.

9. Donation
Betty Blue made a R50 000 donation to the Makeup Institute of South Africa, a registered public benefit organisation. Betty Blue did receive the necessary section 18A income tax certificate for the donation made from the institute.

REQUIRED:
Calculate the tax liability of Betty Blue (Pty) Ltd for the 31 December 2013 year of assessment. You must start your calculation with the taxable income of R2 356 000, taking into account the above-mentioned transactions for taxation purposes only.

SUGGESTED SOLUTION: ASSIGNMENT 2/1/2014
QUESTION 1 (20 marks, 24 minutes)
Calculation of the tax liability of Betty Blue (Pty) Ltd for the year of assessment ended 31 December 2013:

<table>
<thead>
<tr>
<th>Description</th>
<th>R</th>
<th>(marks)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income (given)</td>
<td>2 356 000</td>
<td>(marks)</td>
</tr>
<tr>
<td>Insurance premium paid (August 2013 – December 2013) – s11(a)</td>
<td>102 083</td>
<td>(1)</td>
</tr>
<tr>
<td>Insurance premium prepaid portion (January 2014 – July 2014) – s23H</td>
<td>0</td>
<td>(2)</td>
</tr>
<tr>
<td>Trademark – deductible s11(gB)</td>
<td>75 000</td>
<td>(1)</td>
</tr>
<tr>
<td>Research and development</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Question 1

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries paid before approval was obtained – deductible R451 440 x 100%</td>
<td>(451 440)</td>
<td>(1)</td>
</tr>
<tr>
<td>Salaries paid after approval was obtained – deductible R189 000 x 150%</td>
<td>(283 500)</td>
<td>(1)</td>
</tr>
<tr>
<td>Design – deductible s11(gC) R120 000 x 10% p.a.</td>
<td>(12 000)</td>
<td>(1)</td>
</tr>
<tr>
<td>Bad debts – deductible s11(i)</td>
<td>(60 000)</td>
<td>(1)</td>
</tr>
<tr>
<td>Doubtful debts allowance – 2013 s11(j): R123 000 x 25%</td>
<td>(30 750)</td>
<td>(1)</td>
</tr>
<tr>
<td>Doubtful debts allowance – 2012 add back</td>
<td>22 500</td>
<td></td>
</tr>
<tr>
<td>VAT penalty – not deductible s23(d)</td>
<td>0</td>
<td>(1)</td>
</tr>
<tr>
<td>SDL – interest – not deductible s23(d)</td>
<td>0</td>
<td>(1)</td>
</tr>
<tr>
<td>Salaries and wages – s11(a)</td>
<td>(1 200 000)</td>
<td>(1)</td>
</tr>
<tr>
<td>Contributions to pension fund – s11(l) limited to 10% x R1 200 000 = R120 000</td>
<td>(110 000)</td>
<td>(2)</td>
</tr>
<tr>
<td>Recoupment of lipsticks sold to staff: 40 x (R65 - R30)</td>
<td>1 400</td>
<td>(2)</td>
</tr>
<tr>
<td>Taxable income before s18A deduction</td>
<td>55 127</td>
<td></td>
</tr>
<tr>
<td>Section 18A deduction</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Actual R50 000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Limited to 10% x taxable income = R55 127 (1) x 10% (1) = R5 513</td>
<td>(5 513)</td>
<td>(2)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>49 614</td>
<td></td>
</tr>
<tr>
<td>Tax liability (R49 614 x 28%)</td>
<td>13 892</td>
<td>(1)</td>
</tr>
</tbody>
</table>

**QUESTION 2 (30 marks, 36 minutes)**

**Question 2.1 (17 marks, 20 minutes)**

During the 2012 year of assessment, Betty Blue acquired a 70% shareholding in a South African company called Natural Lashes (Pty) Ltd that manufactures mascara using only organic ingredients. Betty Blue and the only director of Natural Lashes are the shareholders of the company. Betty Blue and the director do not hold any other shareholding in other companies. Natural Lashes had a turnover of R1,5 million for the December 2013 year-end from the sale of mascaras alone. It also received income from consulting fees of R220 000. These consulting fees relate to fees earned by the director, as he is known to be a research expert in the field of organic ingredients. Natural Lashes also had a capital gain of R87 000 that resulted from the sale of one of their mixing machines. The company does not earn any investment income.

The financial accountant at Betty Blue has asked you to advise them on whether or not Natural Lashes can qualify as a small business corporation and be taxed accordingly.

**REQUIRED:**

Determine whether Natural Lashes (Pty) Ltd would qualify as a small business corporation. You must address each requirement and apply it to the facts you are given above and reach a conclusion.

**MARKS** 17
SUGGESTED SOLUTION: ASSIGNMENT 2/1/2014

QUESTION 2

Question 2.1 (17 marks, 20 minutes)

1. The company must either be a close corporation, co-operative or a private company. (1)
   Natural Lashes is a private company. (1)

2. All the shareholders of the company must be natural persons. (1)
   Not all the shareholders are natural persons. Betty Blue (Pty) Ltd is not a natural person and
   the director is a natural person. (1)

3. The gross income for the year must not exceed R14 million. (1)
   The gross income of turnover and consulting fees is less than R14 million. (1)

4. The shareholders are only allowed to have permitted shareholdings. (1)
   This is not applicable, since this requirement applies to all shareholders that are natural
   persons. This is not the case, since one of the shareholders is not a natural person. (1)

5. The investment income and income from a personal service must not make up more than 20%
   of the revenue receipts and capital gains. (1)
   The company has no investment income. (1)
   The consulting fees of R220 000 are considered income from a personal service. (1)
   This meets the definition of a personal service as the service is rendered by a person who holds
   a share in the company, (1) being the director, and the service is in the field of research. (1)
   Therefore: 20% x (revenue receipts + capital gains) = 20% x (R1 500 000 + R220 000 +
   R87 000) (1)
   = R361 400 is the limit. (1)
   The R220 000 personal service income is less than the limit of R361 400. (1)

Conclusion (1): Natural Lashes does not qualify as a small business corporation because not
all the shareholders are natural persons, which is a requirement.

Question 2.2 (13 marks, 16 minutes)

Natural Lashes has provided for bonuses for all its employees in the 31 December 2013 financial year. The
director would like to know if the expense is deductible for tax purposes in the 2013 year of assess-ment.
He tells you that the bonuses will only be paid out to the employees if the turnover of the company reaches
R5 million by 30 June 2014.

The journal entry relating to the provision for bonuses is:

<table>
<thead>
<tr>
<th>Dr Bonuses (Expense)</th>
<th>Cr Provision for bonuses (Liability)</th>
</tr>
</thead>
<tbody>
<tr>
<td>R450 000</td>
<td>R450 000</td>
</tr>
</tbody>
</table>

REQUIRED:

Discuss whether or not the R450 000 is deductible in terms of the general deduction
You must refer to a relevant court case.
The preamble of s11 requires that the expense must be laid out for purposes of trade. Natural Lashes (Pty) Ltd is carrying on a trade, as it is in the business of manufacturing and selling organic mascara. (1)

Section 11(a) requires the following: (for listing all the s11(a) requirements (3))

1. Expenditure and losses: Even though the amount of R450 000 is not an immediate cash outflow, there is an amount that will need to be settled in cash which would represent expenditure. (1)

2. Actually incurred: before an expense can be deducted, it must be unconditional (1), that is, the expense must not be contingent on an event that may or may not occur in the future. (1) The R450 000 bonus provision will only be paid out at a future event, that is, the company reaching a turnover of R5 million. (1) An important tax case that dealt with the “actually incurred” requirement was Edgars Stores v CIR 50 SATC 81. (1)

3. In the year of assessment: The expense relates to the 2013 financial year, that is, the journal entry relates to the 2013 year of assessment. (1)

4. In the production of income: The payment of bonuses in itself doesn’t produce income, but the action of paying a bonus to the employees concerns the production of income, as it relates to the salaries and wages incurred in the production of income of the company. (1)

5. Not of a capital nature: The expense is not creating an enduring benefit and is not of a capital nature. (1)

Conclusion (1)
Because the expenditure does not meet all the section 11(a) requirements, it is not allowed as a deduction.
Provision is specifically prohibited in terms of section 23(e) (1 bonus mark)