CHAPTER 3

BUSINESS ENTITIES

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3.1 INTRODUCTION

Chapters 1 and 2 have covered income tax from the point of view of an individual who earns income from employment and passive income. However, there are other types of business entities besides an individual.

Chapter 3 looks at the individual and their taxable income in the context of operating a business as a sole proprietor. The system of taxation for partnerships, companies, and close corporations is then explored.

Learning Objectives

By the end of the chapter, you should be able to:

- Understand the difference between an independent contractor and an employee and why there needs to be distinction between the two.
- Understand how trading income is incorporated into the taxable income calculation.
- Understand the concept of a company, how it is taxed and how this differs from the taxation of individuals.
- Understand the concept of a small business corporation and how it is taxed.
- Understand why there is provisional tax.
- Calculate the first, second and third provisional tax payments.
- Calculate the penalties and interest relating to provisional tax payments.

3.2 INDEPENDENT CONTRACTORS AND SOLE TRADERS

3.2.1 INDEPENDENT CONTRACTOR

As payments made to independent contractors are, generally, for services rendered, such amounts fall within the preamble to remuneration (as for employed individuals – see Chapter 1). In the absence of any further provisions this would mean that a person would have to withhold employees' tax from any amounts paid to another person for services rendered, whether independent or not. This would clearly be unmanageable – you could not be expected to withhold tax from the plumber who comes to your house to fix your drains. The definition of 'remuneration' in the Fourth Schedule therefore contains an exclusion for payments made to persons carrying on a separate trade from the person to whom the services are rendered.

The exclusion from the definition of remuneration requires that a person be carrying on an independent trade. The trade shall not be considered independent if it has to be performed mainly at the premises of the person from whom payment is received and is subject to his or her supervision either as to the way in which the work is performed or to the number of hours that are worked.

It is important to note that supervision and control is only a factor indicating employment if the person is supervised or controlled mainly at the premises of the employer. If a person is told when to start work and how long to work each week, this is control as to his hours of work and he would not be carrying on an independent trade if this was done at the premises of the employer. As an alternative to hours of work, if the employer controls the manner in which the employee has to work at the employer's premises this also means that the employee is not carrying on an independent trade. The control as to the manner of work usually means a close managing of the employee's time. Requiring a person to use the tools supplied by the employer could also be seen as a way of controlling that person's manner of working. The 'control or supervision' test is a difficult test to apply, because a professional or a skilled worker will need very little supervision, but could still be an employee. The 'Dominant Impression Test Grid' has been used by SARS to determine the extent to which a person is under an 'employer's control'. Note that in terms of the definition above, supervision or control does not have to come from the employer directly. An employer can, for example, hire a consultant for the specific purpose of providing supervision or control, and this will be sufficient to satisfy the requirements of the definition.

Where a person has three or more full-time employees who are not connected to him, however, he is deemed to carry on an independent trade. It is submitted that the determination of whether an employee is full-time depends on the employer's standards and practices. In other words, if the business hours of the employer total, say, 30 hours a week, then provided that the employee's contract is, normally, to work for the full 30 hours (except for leave taken in terms of a normal practice), such person is a full-time employee. It is submitted that the fact that the employee may have another job in the evenings or at night does not make that person a part-time employee of the company that employs him during the day.

Also, if the normal work week in relation to the business is 30 hours, and an employee works for 1 hour each morning, and has no other job, he is not a full-time employee. The reference to being engaged, on a full-time

basis, in rendering the service referred to, means that the employee, in addition to being employed full-time by the company, must also spend all his or her time on that part of the business of the company of rendering the services.

It is important to distinguish an employee from an independent contractor, because it does not only affect the payer's responsibility to deduct employees' tax, but the payee may also be stopped (in terms of section 23(m)) from deducting most of his operating expenses from his income if he is a common law employee.

3.2.2 CASE STUDY – INDEPENDENT TRADE

Mr D carried on the business of manufacturing tables and employed a team of five carpenters, working under one foreman, in his factory. Except for the fact that one of the carpenters is the foreman's brother, and two carpenters are twins, none of the individuals are connected to each other. Mr D was near to retirement and was worried that if he retired and closed the business, his employees would not be able to work on their own. He therefore wanted to help the employees set up their own business so that they could develop entrepreneurial skills with his support, until such time as he was happy that they knew enough about all aspects of the business to go on their own. He had a meeting with the employees and they said that they would prefer to keep on working for the foreman. They had no interest in acquiring equity in the business.

Mr D therefore entered into an agreement with the foreman in terms of which the foreman, as a sole proprietor, would employ the five carpenters and provide a service to Mr D on a labour-only basis, using the factory premises and the tools and equipment supplied by Mr D, as well as the raw materials supplied by Mr D, to manufacture tables. The foreman was free to dismiss any of the carpenters and hire different individuals without interference from Mr D.

Mr D would pay the foreman on a time basis and would not be involved at all in the day-to-day running of the manufacturing business. He would help the foreman, who would become an independent contractor, with the various back-office functions (accounting, tax, and payroll). Over time the foreman would acquire his own equipment and eventually rent the premises from Mr D. Mr D also intended to teach the foreman about designing and marketing the product, and dealing with customers. Until such time, however, Mr D designed the tables, advertised in the magazines and on the internet, and acquired orders. He then gave the specifications to the foreman who would employ his team to manufacture the tables on a labour-only basis. Mr D did require the foreman to work on the factory premises so that he could keep a check on the quality of the work, and ensure that deadlines would be met. Mr D also required that the team be present from 8.25 a.m. to 5.15 p.m. each Monday to Friday, for at least 48 weeks per year, per individual.

The foreman was free to work for other people, but then he would pay Mr D for the use of the premises and equipment used in that part of the business, and would have to purchase his own raw materials. In the beginning, all of the work would come from Mr D, but over time it was hoped that the foreman would build up a large business with a wide customer base.

Initially it was agreed that Mr D would pay the foreman R70 000 (plus VAT) per month for the first 12 months, with the rate and method of payment to be renegotiated at the end of the 12-month period.

The question arises as to whether the payment to the ex-foreman, once this arrangement is entered into, is subject to employees' tax. If the amount is not 'remuneration' as defined, there will be no employees tax leviable on the R70 000 per month.

Looking at the matter, the following is important:

1. The services are required to be performed at the premises of Mr D, therefore the first requirement of the provision set out above is met.
2. Mr D controls the hours of work as well (8:25 a.m. to 5:15 p.m.), so this requirement is met.
3. However, provided that the ex-foreman can keep at least three carpenters fully employed for the year (not counting his brother due to the connected person restriction), the further proviso would apply and the ex-foreman would be deemed to be carrying on an independent trade. The fact that two of the carpenters are twins does not matter as they are not connected to the ex-foreman.

3.2.3 SOLE TRADERS

Sole traders are, generally, those natural persons earning income from trading in their personal capacity. For example, the owner of a corner retail shop selling convenience foods would be a sole trader as the business is not in the form of a legal entity and is not an independent contractor, as the owner is not rendering a service, but selling a product.

Sole traders, like independent contractors, are entitled to trading deductions and capital allowances against their trading income. Sole traders have the additional complication of separating their trading income and deductions from their passive income and personal expenses (see chapters 2 and 4).

3.2.4 MULTIPLE TRADES

Not only can sole traders have multiple trades, for example a retail trade and a rental trade, but sole traders and independent contractors may also be operating as employed individuals. Each of these trades must be separately considered and finally combined when determining the normal tax liability of such persons.

Example

Mr Jones runs a shop selling convenience foods. He is also employed by a large corporation as a food technologist. Assuming he is paid a salary of R30 000 per month, earns R60 000 monthly from selling convenience foods and qualifies for monthly deductions of R20 000, his taxable income for normal tax would be determined as follows:

Trade 1 – Employment

His employment trade annual income is R30 000 x 12 =	R360 000

Trade 2 – Retail shop

Gross income R60 000 x 12 =	R720 000
Less qualifying deductions R20 000 x 12 =	(R240 000)
Trade 2 taxable income	480 000
Total taxable income is R360 000 + R480 000 =	R840 000

3.3 PARTNERSHIPS

A partnership is a legal relationship arising from an agreement between two or more persons. It is not defined as a person in the Income Tax Act, and for income tax purposes it is therefore not regarded as a taxpaying entity.

The partners are taxable in their individual capacities. In terms of section 24H any income which has been received by or accrued to the partners in common (i.e. to the partnership) is deemed to accrue to the partners in their profit-sharing ratio on the same date on which it is received by or accrues to the partnership. Expenses and allowances relating to such amounts are also deemed to be those of the individual partners.

The purpose of this provision is to override a legal principle that the partner's share of profits only accrue to him at the end of the partnership's financial year, when the profits are brought to account.

Additional notes on partnerships

- The source of partnership profits is located where the services of each partner are rendered.
- Partners are taxed on their profits earned, irrespective of their drawings.
- When a partner resigns, dies or retires, the partnership comes to an end.
- When a new partner is admitted, the old partnership comes to an end and a new partnership comes into existence.
- If a partner sells his goodwill, the receipt is of a capital nature, whether paid in a lump sum or in instalments. If the goodwill is sold in return for an annuity, the seller is taxed on the annuity received in terms of paragraph (a) of the gross income definition, but the purchaser gets no deduction for the annuity paid because it is of a capital nature.

  However, s11(m) provides for a deduction of annuities paid to former partners if the following conditions are fulfilled,

  - the person had been a partner for at least 5 years;
  - retired on grounds of old age, ill health or infirmity; and
  - the Commissioner is satisfied that the amount is reasonable,
  - in relation to the services rendered by the partner in the past,

  - as well as in relation to the profits made in the partnership; and
  - the payment is not a consideration in respect of some interest in the partnership, such as goodwill.

- Where a partner sells part of his share in the partnership, he recoups a proportionate share of the allowances on the assets held by the partnership.
- Paragraphs (d) (termination gratuities) and (i) (fringe benefits) of the gross income definition cannot apply to partners because they are neither the holders of an office nor employees of the partnership.
- If a debt owing to the partnership goes bad, the s11(i) deduction is only available to those partners who originally had the sale giving rise to the debt included in their income.

Example – New partner admitted

Black and Blue are partners sharing profits on an equal basis. Their debtors at 29 February 2013 amounted to R80 000. On 30 June 2013 one of these debtors, amounting to R15 000, went bad.

Brown was admitted into the partnership on 30 April 2013. The partners now each share in 1/3 of the profits. The s11(i) bad debt write-off which each partner may claim in respect of the R15 000, for the year ended 28 February 2014 is:

Black (R15 000 x 1/3)	R 5 000
Blue (R15 000 x 1/3)	R 5 000
Brown	-
	R10 000

Brown is not allowed a deduction in terms of s11(i) because the income from the transaction which gave rise to the debtor was never included in his income.

- Insurance premiums paid by the partnership on the lives of the partners cannot be claimed as a deduction in terms of section 11(w), which only applies to policies in respect of employees. However, if the partnership pays the premiums on individual life policies for the partner's own benefit, it is SARS practice to give the partnership a deduction and include the premium paid in the partner's taxable income. In effect such a premium is treated as the partner's share of profits.
- For Value-Added Tax (VAT) purposes, the partnership is treated as a person or vendor, separate from the partners, even though it is not a legal entity. A change in the composition of the partnership does not affect the VAT status of the vendor as long as one or more of the original partners carry on the business as a partnership.

3.4 COMPANIES

3.4.1 DEFINITION OF COMPANY

For income tax purposes the definition of 'company' is wider than the legal definition and includes:

- South African companies (any association, corporation or company incorporated in South Africa, registered as a company – paragraph (a) of the definition of 'company').
- South African public entities (any association, corporation or company established under any South African law – para (a) of the definition of 'company'). This would include universities, for example, and the South African Reserve Bank.
- Foreign companies (any association, corporation or company incorporated under the law of any other country – para (b) of the definition of 'company').
- Co-operatives – para (c) of the definition of 'company'.
- South African charities, etc. (any association, formed in South Africa, to serve a specified purpose beneficial to the public or a section of the public - this would include certain charities and foundations even if they were not registered as companies – para. (d) of the definition of 'company').
- Foreign collective investment schemes (an arrangement or scheme carried on outside South Africa, where members of the public invest in a collective investment scheme, i.e. the investors contribute to the scheme and hold a participatory interest – para (e)(ii) of the definition of 'company').

- Close corporations – para (f) of the definition of 'company'.

An entity is incorporated when it is entered in a register and given juristic personality (in terms of the law of the country) so that it exists as a legal entity apart from its members or owners. A 'collective investment scheme' is one in which 2 or more people, companies, etc. (investors) contribute money or other assets to a company or trust and then hold a share or interest in that company or trust as a way of sharing in the investment. Collective investment schemes are often referred to as "managed funds", "mutual funds", or simply "funds". The Collective Investment Schemes Control Act deals with schemes in which the public are invited to invest.

When the term "company" is used in the Income Tax Act, it must be read as referring to a close corporation and a co-operative as well. The definition specifically excludes a 'foreign partnership'.

3.4.2 FINANCIAL YEAR END AND YEAR OF ASSESSMENT

A company's year of assessment is the same as its financial year. Unlike individuals and trusts, a company's financial year end need not end on the last day of February.

Note: The Budget Speech is usually presented in February each year, while the detailed amendments are only tabled in Parliament towards the end of July and November. The amendments to the rates for the 2013/2014 tax year were tabled in February 2013, and the detailed amendments to the legislation were promulgated later in the year.

The new tax rates announced in the Budget Speech take effect immediately, that is, for individuals with effect from 1 March and for companies with year-ends falling within the period from the 1st of April of that year to the 31st March of the next year. The amendments to the Act are generally only effective for year-ends from 1 January to 31 December of the *following* year (the 'general effective date' of the amendments), unless otherwise provided in the amending act.

Example

The financial year-end of a company falls in the period:	*Taxable income is calculated by referring to:*	*Tax rate used is that announced in:*
January to March 2013	2012 Act	2012 Budget
April to December 2013	2012 Act	2013 Budget
January to March 2014	2013 Act	2013 Budget

3.4.3 SPECIFIED DATE

This is the last day of the year of assessment of the company.

3.4.4 EQUITY SHARE CAPITAL

'Equity share' is defined in section 1. An equity share (from 1 April 2012) is:

- A share in a company
  - Excluding any share that does not carry a right to participate beyond a specified amount in a distribution.
- Note that the equity shares need not have voting rights.
- The definition covers shares in South African companies as well as shares in foreign companies.

Ordinary shares are equity shares. A member's interest in a close corporation is an 'equity share'. Any interest in the capital of a company is a share of that company or in that company.

Preference shares issued will only be equity shares if they are participating preference shares, i.e. -

- they participate in profits to an unlimited extent, or
- they participate in the distribution on liquidation.

Therefore, if a preference share does not participate in profits beyond a specified amount nor in capital beyond the nominal value of the share, it is not an equity share. These shares are usually referred to as 'non-participating preference shares'.

3.4.5 PUBLIC AND PRIVATE COMPANIES

The main reason for distinguishing between public and private companies, for tax purposes, is that public companies are exempt from donations tax.

Distinguishing between private and public companies

- If a company is registered as a private company under the Companies Act it is also a private company for tax purposes. Such a company can never be classified as a public company for tax purposes.
- A close corporation is a private company for tax purposes.
- If a company is registered as a public company under the Companies Act it may or may not be a public company for income tax purposes. Its tax classification will be determined in terms of section 38.

The Commissioner will (upon the request of a company) inform the company whether it is recognised as a public or private company for tax purposes. There is a list of which companies will be regarded as public companies. All companies which are not public in terms of section 38 will be regarded as private companies.

Public company quoted on a stock exchange

Any company having all classes of its equity shares quoted on a stock exchange on its specified date (year-end) shall be a public company, if the Commissioner is satisfied that;

- the stock exchange is a recognised one under adequate control,
- normal stock exchange rules apply to protect the interests of the public,
- the memorandum and articles of association/memorandum of incorporation of the company do not restrict the sale or transfer of any class of its shares to the general public, and
- the general public was, throughout the year of assessment, interested directly or indirectly, via shareholding in any other company, in more than 40% of every class of equity share issued by the company.

Public company not quoted on a stock exchange

Any company not being a private company under the Companies Act (nor a close corporation) shall be a public company, if the Commissioner is satisfied that:

- the general public was, throughout the year of assessment, interested directly or indirectly, via shareholding in any other company, in more than 50% of every class of equity share issued by the company, and
- no person enjoys benefits that he would not have enjoyed had the company been under the control of a board of directors acting in the best interests of all shareholders as if it was a quoted company.

Companies automatically classified as public companies

PBO: Any company which has been approved as a ‘public benefit organisation’ in terms of the provisions of section 30(3) of the Income Tax Act.

Co-op: Any co-operative registered under the Co-operatives Act.

Insurance: Any insurance company subject to tax under section 28, 29, or 29A (long-term and short-term insurance).

Any *public utility* company.

Gold and diamond mining: Any company whose sole or principal business in the Republic is gold or diamond mining.

Non-resident ships & aircraft companies: Any company to which the provisions of section 33 apply. These are owners or charterers of ships or aircraft neither ordinarily resident nor registered, managed or controlled in the Republic.

3.4.6 CALCULATION OF A COMPANY'S TAX LIABILITY

Companies pay normal income tax (usually at 28% - see Appendix D) on their taxable income.

The taxable income of a company is calculated in the same way as an individual's taxable income. There are certain provisions of the Act which apply only to companies, however, and certain provisions which apply only to individuals.

3.4.7 RATES OF NORMAL TAX

The rates of normal tax for companies are set out in Appendix D at the back of the book.

- Normal company or close corporation: 28%
- Small business corporation: 0%, 7%, 28%
- Long term insurer: 0%, 28%, 30%
- Micro business: taxed on turnover: 0%, 1%, 2%, 4%, 6%

3.5 SMALL BUSINESS CORPORATIONS

Special rates of tax apply to small business corporations (SBC's).

A small business corporation is defined as follows:

- any close corporation, co-operative or private company (in terms of the Companies Act)
- all the shareholders of which are natural persons (for the entire year of assessment)
- the gross income of which does not exceed R14 million for the year of assessment
- none of the shareholders or members of the SBC at any time during the year of assessment (of the SBC) holds any shares or has any interest in the equity of any other company other than certain 'permitted' shareholdings These 'permitted shareholdings' are holdings in:
  - a listed company;
  - any portfolio in a collective investment scheme or
  - any company contemplated in s10(1)(e)(i)(aa), (bb) or (cc) (sectional title body corporates, share block companies, and associations formed to manage the collective interests of its members);
  - less than 5% in a social or consumer co-operative or a co-operative burial society or any other similar co-operative if all of its income is solely derived from its members;
  - less than 5% in a primary savings co-operative bank or primary savings and loan co-operative bank;
  - any venture capital company as defined in section 12J
  - any friendly society (as defined in the Friendly Societies Act);
  - any company, close corporation, or co-operative if the company, CC, or co-op:
    - ~ has not during *any* year of assessment carried on any trade; *and*
    - ~ has not ever owned assets of more than R5 000 in value.
  - any company, close corporation or co-operative if the company, close corporation or co-operative has taken the steps contemplated in section 41(4) to liquidate, wind up or deregister (and the steps have not been withdrawn or invalidated).
- Investment income and income from a 'personal service' do not make up more than:
  - ~ 20% x (revenue receipts & accruals + capital gains).

Investment income is defined as:

- dividends, royalties, rental from immovable property, annuities, similar income

- interest per section 24J (certain amounts are excluded, such as interest from a primary saving co-operative bank, and section 24K amounts)
- proceeds derived from investment or trading in financial instruments, marketable securities or immovable property

'Personal service' is defined as one of the following if it is rendered personally to clients by a person who holds an interest (shares or member's interest) in the company or close corporation:

- any service in the field of accounting, actuarial science, architecture, auctioneering, auditing, broadcasting, consulting, draftsmanship, education, engineering, financial service broking, health, information technology, journalism, law, management, real estate broking, research, sport, surveying, translation, valuation, veterinary science.

Notes:

1. Small business corporations (SBC's) also qualify for the 100% section 12E allowance in respect of manufacturing plant and machinery, and a normal wear and tear allowance or a 50:30:20 write-off (i.e. over 3 years) in respect of other assets (see Chapter 5).
2. Personal service providers (as defined in the Fourth Schedule) cannot be SBC's.
3. Dividends paid by an SBC are subject to Dividends Tax in the normal way.

Example – Small Business Corporation (SBC)

Mr D owns all the members interest of ABC CC. It renders accounting services and sells computer programs. Mr D only has "permitted" shareholdings in other entities.

The gross income of ABC CC for the year of assessment is as follows:

Sales of computer programs	R1 940 000
Accounting services rendered by Mr D	240 000
Accounting services rendered by Mrs D	700 000
Dividends	100 000
Interest income	200 000
	R3 180 000

In addition to the above, the CC made a capital gain of R900 000 on the sale of a building in which it ran its business. The building was sold for R2 million. The CC's tax deductible expenses for the year of assessment amounted to R2 430 000.

Calculate the tax payable by ABC CC. (ABC CC is not a 'personal service provider').

Step 1 – Is ABC CC a small business corporation?

- The member is a natural person (Mr D).
- The "gross income" is not more than R14 million.
- It is not a personal service provider.
- The other shareholdings of the member are all permitted
- 20% of revenue receipts and capital gains is
  20% x (3 180 000 + 900 000) = R816 000
- Income from personal services and investment income:

- Mrs D	R240 000
- Dividends	100 000
- Interest	200 000
	R540 000

This is less than the R816 000 calculated above. The proceeds from the sale of the building (R2 million) is not taken into account as investment income because it is capital in nature and is therefore not part of the total on which the 20% is based.

Conclusion: ABC CC is a SBC

Step 2 – calculate the taxable income

Gross income (as above)		R3 180 000
Less:	Exempt income (dividends)	(100 000)
	Income	R3 080 000
Less:	Deductions	(2 430 000)
		R 650 000
Add:	Taxable portion of capital gain: R900 000 x 66.6% =	599 400
	Taxable income	R1 249 400

Step 3 – calculate the tax per the table:

On first R63 556 =	0
R350 000 – 63 556 = R286 444 x 7%	20 051
R1 249 400 – 350 000 = R899 400 x 28%	251 832
	R271 883

3.6 CLOSE CORPORATIONS

A close corporation (CC) is a body corporate, registered in terms of the Close Corporations Act (69 of 1984). It is a separate legal entity which is therefore a taxpayer in its own right. It may have between 1 and 10 members and membership is restricted to natural persons and trusts.

Close corporations are falling away in South Africa. No new close corporations are allowed to be registered, but those currently registered can continue until an unspecified future date, when they will be required to convert to private companies.

3.6.1 TAX IMPLICATIONS OF CLOSE CORPORATIONS

A close corporation is a private company for income tax purposes, and is taxed as a company. A close corporation can also be classed as a small business corporation (SBC), or as an employment company (depending on the circumstances).

Any person who holds an office or performs functions similar to those of a director of a company is defined as a director. The Close Corporations Act provides that every member shall be entitled to participate in the carrying on of the business of the corporation. It is further provided that this rule may be varied in the association agreement. This means that unless the association agreement provides otherwise, every member of a close corporation is a director (for income tax purposes) in terms of the definition in the Income Tax Act.

Under certain circumstances, members (like directors of companies) can be held personally liable for the VAT and the employees' tax payable by the close corporation.

3.7 DIVIDENDS TAX

With effect from 1 April 2012 Dividends Tax replaced Secondary Tax on Companies (STC). Dividends Tax is levied at the rate of 15% of the amount of 'any dividend paid by any company other than a headquarter company.' It is a withholdings tax that is withheld by the company before paying the net amount (dividend declared less dividends tax) over to the shareholder.

Example –Dividends Tax

Company A declares a dividend of R100 to its shareholders.

The shareholders of Company A will be charged Dividends Tax of R100 x 15% = R15. Company A must withhold this amount and pay it to SARS. The shareholders will receive R85, while the total cash outflow from Company A will be R100.

Close corporations are not specifically referred to in the definition of 'dividend' in section 1 of the Income Tax Act. This definition refers to any amount transferred or applied by a resident company for the benefit of any shareholder. However the definition of company in section 1 includes a close corporation. Furthermore the definition of share in section 1 effectively includes a member's interest in a close corporation. The result is that any distribution of profits by a close corporation to its members constitutes a dividend for the purposes of the Income Tax Act and will be subject to Dividends Tax. Such distributions, being a dividend as defined, are generally exempt from tax (per section 10(1)(k)) in the hands of the members of the close corporation.

Dividends Tax is beyond the scope of this book and will not be covered in further detail.

3.8 PROVISIONAL TAX

3.8.1 GENERAL

Provisional tax is a mechanism for the advanced collection of normal tax from taxpayers. All companies are subject to provisional tax. Because employees' tax is also an advanced collection of normal tax, only individuals who have income other than remuneration are subject to provisional tax. This would include independent contractors, sole traders and investors. Note that provisional tax is not a separate tax, but a method of tax collection.

A provisional taxpayer includes:

- Any person who derives income which is not remuneration (as defined) or an allowance or advance (contemplated in section 8(1)).
- Any company.
- Any person notified by the Commissioner that he is a provisional taxpayer.

Exemptions

The following persons (considered in this book) are exempt from the payment of provisional tax:

- Any approved tax-exempt Public Benefit Organisation;
- Any natural person under the age of 65 who does not derive income from the carrying on of any business if:
  - (i) the taxable income of the person will not exceed the tax threshold (defined in para 1); or
  - (ii) the taxable income derived from interest, foreign dividends or the rental from the letting of fixed property does not exceed R20 000.

> Remember that the "tax threshold" is defined as follows: "*in relation to a natural person means the maximum amount of taxable income of that person in respect of a year of assessment which would result in no tax payable when the rates of tax contemplated in section 5 of this Act and the rebates contemplated in section 6 of this Act for that year of assessment are applied to the taxable income of that person*"

  For the 2014 year the tax threshold for a person under 65 is R67 111 per year, for a person 65 years or older it is R104 611 and for a person 75 years or older it is R117 111.

- Any natural person (other than a director of a private company) who, on the last day of the year of assessment, will be 65 years or older, and satisfies the Commissioner that his taxable income:
  - (i) will not exceed R120 000,
  - (ii) will not be derived wholly or in part from the carrying on of any business, and
  - (iii) will not be derived otherwise than from remuneration, interest, foreign dividends, or rental from the letting of fixed property.

Payment of provisional tax

Provisional taxpayers are required to make two compulsory provisional tax payments during the year of assessment based on their estimate of taxable income.

- The first is payable within the first six months of the year of assessment.
- The second is payable by no later than the end of the year of assessment. Provisional payments are merely advance payments in respect of the normal tax payable for the year. In certain cases the taxpayer may make a third, voluntary, provisional tax payment, often referred to as a topping up payment.

The provisional payments for any year will be reflected as a credit against the normal tax as finally assessed for that year. This means that if the provisional tax paid throughout the year is greater than the calculation of the tax as per the tables (and after rebates), then SARS will refund the taxpayer.

3.8.2 PROVISIONAL TAX PAYMENTS

The Fourth Schedule sets out the provisional tax calculation for both companies and individuals. The difference between the calculation of provisional tax for companies and individuals is in the tax rate (and rebates for individuals) and that the tax calculated for individuals (and personal service providers) must be reduced by any employees' tax paid in arriving at the provisional tax payable.

First Payment

The first provisional tax payment must be made six months before the year end of the taxpayer. In the case of a taxpayer with a February year end, this means that the first payment must be made not later than 31 August of the preceding year. For example, for the year ended 28 February 2014 the first 2014 provisional payment must be made no later than 31 August 2013.

The amount payable is computed by:

(1) estimating the total expected taxable income for the year,

(2) calculating the tax payable on this taxable income,

(3) deducting the rebates (in the case of individuals),

(4) dividing the tax payable by two,

(5) deducting any employees tax paid for the first six months of the tax year (in the case of individuals), and

(6) paying the resultant difference (if any) to SARS.

By default most taxpayers use the 'basic amount' to determine their estimated taxable income for their first provisional tax return. The 'basic amount' is the taxable income reflected in the most recent assessment received from SARS and usually appears on the provisional tax form. If the most recent assessment was received less than 14 days before the provisional payment is made, the basic amount is the taxable income reflected in the preceding assessment. Note that the basic amount must exclude any taxable capital gains, the taxable portion of any lump sums which are taxed at average rates, and any retirement fund lump sums received or accrued in the year on which the basic amount is calculated.

An estimate of taxable income smaller than an amount known as the 'basic amount' may only be used with the consent of the Commissioner in the case of the first provisional payment. If the estimate is more than the basic amount, it is quite acceptable for the taxpayer to use the basic amount as the estimated taxable income.

If the taxpayer has not been previously assessed the basic amount is nil, but this will not be accepted by SARS. The Commissioner is allowed to increase any provisional tax estimate to an amount that he considers reasonable. He could do this, for example, where it is the taxpayer's first year of assessment. He can also do so if information indicates that the final taxable income is likely to be higher.

Where the last assessment is for a year that is more than one year before the current year, and more than 18 months have passed, the taxable income from that assessment must be increased by 8% per annum. The increased amount is then the "basic amount" for the year. For example, if a 2013 assessment is used to calculate the amount for 2014 the taxable income from the assessment does not need to be increased (due to it being the previous year). If a 2012 assessment is used for the first provisional payment, no increase of the assessed taxable income is required (not more than 18 months). However, if a 2011 assessment is used for the first provisional payment, it will have to be increased by 16% (8% x 2 years).

Notes:

1. Any taxable capital gain included in taxable income is excluded in determining the basic amount. For example if a taxpayer's taxable income (as assessed) for the year ended February

2013 is R260 000 and included in such taxable income is a taxable capital gain of R30 000, the basic amount is R230 000.

2. Provisional taxpayers must request a provisional tax return form (IRP 6) from SARS, usually via e-filing. This form usually reflects the most recent assessed taxable income (the basic amount) at the time of the request.

Second Payment

The second payment must be made by the end of the year of assessment. This means that the second payment must be made by the end of February in the case of a taxpayer with a February year-end.

(1) Tax must be calculated on the total estimated taxable income, (in the case of the second payment a two-tiered system is used – see below),

(2) rebates are deducted (in the case of individuals),

(3) employees' tax paid for the 12 months must be deducted (in the case of individuals),

(4) the first provisional tax payment must be deducted, and

(5) any remaining difference must be paid to the SARS.

3.8.3 TWO-TIER SYSTEM

The Fourth Schedule provides for a two-tiered system for provisional tax estimates by taxpayers.

- Where the actual taxable income for the year is R1 million or less, the estimate of taxable income can be based on the lower of:
  - the taxable income for the year (seriously calculated)
  - the basic amount (adjusted by the 8% per annum escalation if necessary)
- Where the actual taxable income for the year is more than R1 million, the estimate of taxable income must be based on a serious calculation of the taxable income for the year.

Example – Provisional tax of company

A company whose assessment for the year ended 30/6/2011 shows a taxable income of R1 100 000, provides the following information for the 2014 tax year:

- Estimated income for the 2014 year	R900 000

1st 2014 Payment - 31 December 2013

The first payment will be determined using the basic amount which is R1 100 000, increased by 8% per year. Note that if this was the 2012 assessment, there would be no increase as the 18 month requirement would not have been fulfilled. There would also be no escalation if 2013 were the last year assessed.

Taxable income previously assessed = basic amount	R1 100 000
Increase by 8% for 3 years (24%)	264 000
Basic amount	R1 364 000
Tax on R1 276 000 (x 28%)	381 920
Divide by 2 for the first provisional tax payment	R190 960

2nd 2014 Payment - 30 June 2014

Tax on R900 000 (estimated income)	R252 000
Less: - 1st provisional payment	(190 960)
2nd provisional payment	R 61 040

If the company's tax return for the 2014 tax year shows a taxable income of R1 300 000 its assessment will be as follows:

Tax on R1 300 000 (x 28%)		R364 000
Less: - 1st Provisional	190 960	

- 2nd Provisional	61 040	(252 000)
Amount due		R112 000

Note: Because actual taxable income is greater than R1 million, and the second estimate of R900 000 is lower than 80% of the actual taxable income for the year (R1 300 000 x 80% = R1 040 000), an additional tax of 20% of the difference between the tax payable in the second estimate and the tax on R1 040 000 is payable.

The tax on R1 040 000 is R291 200. Therefore the 'penalty' is 20% x (291 200 – 252 000) = R7 840

Example – Provisional tax of individual

A taxpayer (under the age of 65) whose assessment for the year ended 28/2/2012 shows a taxable income of R115 000, provides the following information for the 2014 tax year:

- employees tax paid 1/3/2013 - 31/8/2013	R4 000
- employees tax paid 1/9/2013 – 28/2/2014	R3 000
- Estimated income for the 2014 year	R90 000

1st 2014 Payment - 31 August 2013

The first payment will be determined using the basic amount which is R115 000 (not increased due to 18 month requirement). Note that there would be no escalation if 2013 was the last year assessed.

Taxable income previously assessed = basic amount	R115 000
Tax on R115 000	20 700
Less: Rebate	(12 080)
	R 8 620
Divide by 2	R4 310
Deduct employees' tax	(4 000)
First provisional tax payment	R 310

2nd 2014 Payment - 28 February 2014

Tax on R90 000 (estimated income)		R16 200
Less: Rebate		(12 080)
		R4 120
Less:	- Employees' tax for the year	(7 000)
	- 1st payment	(310)
2nd provisional payment		R nil

If his tax return for the 2014 tax year shows a taxable income of R130 000 his assessment will be as follows:

Tax on R130 000		R23 400
Less: Rebate		(12 080)
		R11 320
Less: - Employees tax	7 000	
- 1st Provisional	310	
- 2nd Provisional	nil	(7 310)
Amount due		R4 010

Note: Because the second estimate of R90 000 is lower than 90% of the actual taxable income for the year (R130 000 x 90% = R117 000) and lower than the basic amount (R115 000), an additional tax of 20% of the difference between the tax payable in the second estimate and the tax on R115 000 is payable.

The tax on R115 000 is R8 620. Therefore the 'penalty' is 20% x (8 620 – 4 120) = R900

The taxpayer's taxable income is not more than R1 million, so the 80% rule does not apply.

3.8.4 PENALTIES ON THE FIRST PROVISIONAL TAX PAYMENT

Underestimate

Although the first provisional tax payment cannot be based on a figure which is less than the basic amount, as adjusted if necessary, unless prior permission of the Commissioner is obtained, there does not appear to be any penalty in the Fourth Schedule if the tax is based on a figure which is less than the "basic amount". Note, however, that if the Commissioner is not satisfied with the estimate he may request a revised estimate from the taxpayer.

Late submission

The Act does not provide for a penalty where the first provisional payment estimate is not submitted timeously.

Late Payment

The Fourth Schedule provides that if any provisional tax is not paid within the period allowed for payment, a penalty of 10% of the amount not paid will be levied on the taxpayer.

The term "the amount not paid" refers to the amount of provisional tax which should have been paid. The penalty will therefore be calculated by determining the first payment which should have been made using the basic amount as an estimate.

If the Commissioner is satisfied that the failure to pay timeously was not due to an intent on the part of the taxpayer to evade or postpone the tax, he may remit all or part of this penalty.

In addition, section 89*bis* provides that interest at the prescribed rate will be payable for as long as the amount remains unpaid. In terms of section 23(d) (see chapter 4) such interest is not deductible for tax purposes.

3.8.5 PENALTIES ON THE SECOND PROVISIONAL TAX PAYMENT

Late submission and late payment

The Fourth Schedule provides that if the estimate of taxable income is not submitted before the last day of the year, a penalty will be imposed and will take the form of additional tax of 20% of the excess of normal tax payable on the taxable income for the year over the sum of the first provisional tax payment and employees' tax for the year. The Commissioner may remit all or part of the penalty if he is satisfied that the taxpayer did not intend to evade or postpone the tax.

In addition, section 89*bis* provides that interest at the prescribed rate will be payable for as long as the amount remains unpaid and in terms of section 23(d) this interest is not deductible for tax purposes.

Underestimate – additional tax

Where the actual taxable income is R1 000 000 or less, in order to avoid the 20% 'additional tax' the second provisional tax payment must be at least equal to the tax on the lesser of:

- The basic amount
- 90% of the actual taxable income for the year

If it is less than both of these amounts, there is a 20% penalty of:

Tax on lower of the basic amount or 90% of taxable income	R XXX
Less: Employees' tax and provisional tax paid by end of the year	(XXX)
Amount subject to 20% penalty	R XXX

Example – Provisional tax 'additional tax'

Mr L, when making his second 2014 provisional tax payment on 28 February 2014, used an estimate of R400 000. His basic amount was R680 000. When he is finally assessed for 2014, his taxable income is R630 000. Calculate the "additional tax" which Mr L will have to pay because his second provisional tax payment was too low.

Solution

First payment

Tax on lower of 90% of actual taxable income or basic amount,			
i.e. tax on R567 000 (90% x R630 000) =		R157 997	
Rebate		(12 080)	
		R145 917	
Tax on actual estimate of R400 000 =	R97 566		
Rebate	(12 080)	(85 486)	(tax paid)
Difference		R60 432	
Additional tax at 20%		R12 086	

Where the actual taxable income for the year exceeds R1 000 000, the taxpayer must seriously calculate other taxable income for the year (by the last day of the year of assessment), and make the provisional tax payment based on this calculation.

If the estimate is less than 80% of the actual taxable income, then the taxpayer will be liable for additional tax calculated as follows:

20% x (normal tax on 80% of actual taxable income – employees' tax and provisional tax paid by end of the year)

Therefore, if an individual's taxable income for the 2014 tax year is R1 500 000, and he estimated that his taxable income was R900 000, and such estimate was not seriously calculated, the additional tax is as follows:

Normal tax on 80% of taxable income of R1 500 000	R397 685
Normal tax paid on R900 000 (assuming no employees' tax paid and that the R900 000 is greater than the amount used for the first provisional tax payment)	(277 685)
Difference	R120 000
Additional tax at 20%	R24 000

And if a company's taxable income for the 2014 tax year is R1 500 000, and it estimated that its taxable income was R900 000, and such estimate was not seriously calculated, the additional tax is as follows:

Normal tax on 80% of taxable income of R1 500 000	R336 000
Normal tax paid on R900 000 (assuming the R900 000 is greater than the amount used for the first provisional tax payment i.e. the sum of the first and second provisional tax payments equals the tax on R900 000)	(252 000)
Difference	R84 000
Additional tax at 20%	R16 800

SARS can waive this penalty in whole or in part if satisfied that *both* of the following apply:

- The provisional tax was seriously calculated with due regard to the factors having a bearing on it, and
- The estimated taxable income or the tax was not deliberately or negligently understated.

SARS's discretion in this regard is subject to objection and appeal.

3.8.6 PENALTIES ON THE THIRD PROVISIONAL TAX PAYMENT

Section 89*quat* makes provision for the charging of interest at the prescribed rate if the total employees' tax and provisional tax payments for the year are less than the normal tax for the year as finally assessed. The interest is charged for a period starting seven months after the year end of individuals and companies with a

February year end and six months after the year end for taxpayers with year ends other than February, and ending on the date of assessment.

So, for example, if the total employees' tax and provisional tax payments made by a taxpayer for the year ended 28 February 2014 amounts to R30 000 and the 2014 assessment which is dated 31 December 2014 reflects tax due of R50 000, interest will be charged on the shortfall of R20 000 for the period 1 October 2014 to 31 December 2014. In order to avoid the payment of interest, the taxpayer may make a third provisional payment of R20 000 on or before 30 September 2014.

The third payment is not a compulsory payment and there is, therefore, no provision for penalties if the payment is late or is underestimated.

Section 89*quat* only applies to:

- companies whose taxable income for the year exceeds R20 000 and
- individuals who are provisional taxpayers and whose taxable income exceeds R50 000.

With effect from a date still to be notified by the Minister of Finance, all taxpayers will become subject to the section 89*quat* interest. It will not be limited to provisional taxpayers.

Three terms are defined in the section:

(a) *CREDIT AMOUNT*

This is the sum of

- all provisional payments for the year
- any employees' tax paid during the year

(b) *EFFECTIVE DATE*

- A date falling 7 months after the last day of the year of assessment for taxpayers with February year ends.
- A date falling 6 months after the last day of the year of assessment for taxpayers with year ends other than the end of February.

(c) *NORMAL TAX*

This is the sum of

- assessed tax for the year
- any additional amount payable in terms of section 76, which has now been repealed, but s89*quat* still applies
- any penalty payable in terms of paragraphs 20 and 20A of the Fourth Schedule

The additional taxes referred to are:

- **Fourth schedule paragraph 20**

  This is a 20% additional tax resulting from an underestimate of the second provisional tax payment.

- **Fourth schedule paragraph 20A**

  This is a 20% additional tax imposed on late submissions of the second provisional tax payment.

Where the normal tax exceeds the credit amount, the taxpayer is charged interest from the effective date. I.e. interest is charged on any additional tax and provisional tax penalties.

Where the credit amount exceeds the normal tax for the year, interest at the prescribed rate will be paid to the taxpayer, on the difference, calculated from the effective date until the excess is refunded.

The Fourth Schedule also provides that any payments made after the effective date will be treated as late payments relating to the period prior to the effective date and will be subject to interest in terms of section 89*bis* and not section 89*quat*. For example, if the credit amount at the effective date is R100 000 and the normal tax for the year is R110 000, interest will be charged from the effective date to the date of assessment on the R10 000 difference in terms of section 89*quat*. If, however, the R10 000 is paid after the effective date but before the date of assessment, interest will only be charged from the effective date to the date of

payment. If the taxpayer pays more than R10 000, say R12 000, after the effective date, the section 89*bis* interest will be charged on R12 000 at the prescribed rate from the effective date to the date of payment, whereas the overpayment of R2 000 will lead to SARS having to refund the R2 000, with interest, calculated from the effective date to the date the overpayment is refunded, at the prescribed rate. The interest paid by the taxpayer is not tax deductible, while the interest received is taxable.

Note that if the taxable portion of a capital gain is not included in the calculation of the third provisional tax payment, the resultant shortfall is also subject to the section 89*quat* interest.

3.8.7 PRESCRIBED RATE OF INTEREST

The "prescribed rate" is defined in section 1 of the Income Tax Act. Paragraph (a) of the definition deals with the rate payable by the Commissioner for the South African Revenue Service to the taxpayer, and paragraph (b) deals with the rate payable by the taxpayer.

Where an amount of tax is not paid on the date prescribed for payment (e.g. on the second date set out on the income tax assessment), interest is payable at the prescribed rate as set out in paragraph (b). Where a refund of tax that has been overpaid is due to the taxpayer by the Commissioner, interest is payable by the Commissioner at the prescribed rate as set out in paragraph (a).

The rates of interest are set out in Appendix E.

Where a taxpayer owes tax, additional tax, penalties, and interest, and he makes payment of part of the amount due by him, section 89*ter*(1A) provides that the payment will firstly be set off against the penalty, then against the interest, and finally against the tax and additional tax due by the taxpayer.

3.8.8 PROVISIONAL TAX EXAMPLE

Example

For the 2012 tax year, Mr X (aged 50) was assessed on a taxable income of R90 000.

Mr X's employer withheld employees tax of R1 960 for the period 1/3/2013 to 31/8/2013 and R2 000 for the period 1/9/2013 to 28/2/2014. Mr X has not yet received his assessment for the year ended 29 February 2013. In August 2013 Mr X calculated his first provisional tax payment for the 2014 year as follows:

Basic amount (2012 assessment not adjusted)	R90 000
Tax per table	R16 200
Less: Rebate	(12 080)
Tax payable	R4 120
Tax payable for 6 months (divided by 2)	R2 060
Employees tax paid	(1 960)
First provisional payment (31/8/2013)	R 100

In February 2014, Mr X feels that his taxable income will only be R75 000, so he calculates his second provisional payment as follows:

Tax payable on R75 000	R13 500
Rebate (as above)	(12 080)
	R1 420
Employees tax paid during the year	(3 960)
First provisional payment	(100)
Second provisional tax payment (28/2/2014)	R NIL

Mr X sends in his tax return for the year ended February 2014 in November 2014, and his actual taxable income for the year ended 28/2/2014, is R120 000. He is assessed on the R120 000 by 1 December 2014 and has to pay the following amounts:

Taxable income 2014 (Actual)	R120 000
Tax on R120 000	R21 600
Rebate	(12 080)
Tax Payable	R9 520

Already paid:

Employees tax	R3 960	
1st Provisional payment	100	
2nd Provisional payment	Nil	(4 060)
Tax payable on assessment		R5 460

In addition Mr X is liable for additional 'penalty' tax and interest.

Additional tax on underestimate

(i) First take 90% of the actual taxable income: R120 000 x 90% = R108 000

(ii) Compare this with the basic amount of R90 000

(iii) Calculate the normal tax on R90 000, i.e. R4 120

(iv) Deduct from R4 120 the tax actually calculated in the second provisional tax payment (not the tax actually paid), i.e. R4 760 – R1 420 = R3 340.

(v) Multiply this difference by 20% to arrive at the penalty payable: R3 340 x 20% = R668

Note that if the Commissioner is satisfied that Mr X had genuinely calculated the R75 000 estimate, the Commissioner may, in his discretion, remit part or all of this additional tax.

Interest (s89quat)

Interest will be payable on the difference between the normal tax plus the additional tax (R9 520 + R668 = R10 188) and the credit amount of R4 060. The interest will be charged for the period 1/10/2014 to 1/12/2014 (date of assessment).

3.9 CONCLUSION

Chapter 3 introduces the concept of the sole trader and partnership and how the individual is taxed in their own name when transacting in a business environment on their own behalf and earning income other than from an employer or passive income.

Companies and close corporations were discussed and it was noted that they are separate legal entities and taxed in their own capacities.

Provisional tax is a method of tax collection that enables SARS to timeously receive tax owing to them.

If one incorporates the last 3 chapters into the tax liability calculation, the result would look similar to:

Gross income s1	
As per the definition, including, but not limited to:	
Salary, commission, leave pay etc *	XX
Fringe benefits *	
Acquisition of asset at less than actual market value	XX
Right of use of asset	XX
Right of use of motor vehicle	XX
Meals, refreshments and vouchers	XX
Free or cheap services	XX
Subsidies & low interest loans	XX
Payment of employees' debt	XX
Medical aid contributions	XX
Medical costs incurred	XX
Trading Income	

Passive income		
Interest income	XX	
Dividend income	XX	
Royalty income	XX	
Purchased annuity receipts	XX	XXX
Less: Exempt income s10		
Non-resident interest exemption s10(1)(h)	XX	
Natural person interest exemption s10(1)(i) *	XX	
Dividend exemption s10(1)(k)	XX	
Royalty exemption s10(1)(*l*)	XX	
Copyright exemption s10(1)(m)	XX	
Special uniform exemption s10(1)(nA) *	XX	
Transfer/relocation costs exemption s10(1)(nB) *	XX	
Ships crew exemption s10(1)(o)(i) *	XX	
Employment outside SA exemption s10(1)(o)(ii) *	XX	
SA government service exemption s10(1)(p) *	XX	
Bursary exemption s10(1)(q) *	XX	
Purchased annuity exemption s10A	XX	(XXX)
Income		XXX
Less: Deductions (mainly s11 to s20 & s23)		
Pension fund deduction s11(k) *		(XX)
Subtotal (needed for RAF calculation - 15% limit)		XXX
Less: Retirement annuity fund deduction s11(n) *		(XX)
Add: Taxable portion of allowances per s8(1) *		
Travel allowance inclusion		XX
Subsistence allowance inclusion		XX
Other allowance inclusions (entertainment)		XX
Add: Taxable portion of capital gains (s26A)		XX
Subtotal (needed for donations deduction - 10% excess)		XXX
Less: Donations deduction s18A		(XX)
Less: Medical deductions s18 *		
- over 65 - disability (with limits)		(XX)
Subtotal (needed for excess medical deduction calculation - 7.5%)		XXX
Less: Excess medical costs deductions s18 *		(XX)
Taxable income		XXX

<u>Individuals and partnerships:</u>

Tax per the table, based on taxable income	XXX
Less: Rebates (normal and medical)	XXX
Tax payable	XXX

<u>Companies:</u>

Taxable income x 28% XXX

*Applicable only to natural persons

3.10 INTEGRATED QUESTION

3.10.1 THANDI GATSO (75 MARKS)

Mrs Thandi Gatso, a resident of Namibia (i.e. a non-resident of South Africa) aged 54, is an employee of Central (Pty) Ltd ('Central' or 'the company'). Central is a South African company, with a head office in Cape Town, where Thandi lives and works. She is also a widow (her husband passed away many years ago) with two children, who are dependants on her medical aid. Her son, after an unfortunate motor vehicle accident last year, is disabled and has a prosthetic limb.

Employment

Thandi receives a monthly salary of R22 000 and contributes 8% of her salary to a provident fund. The company contributes the same amount to the provident fund.

Thandi contributes R1 900 a month to a medical aid fund, which Central deducts from her gross salary and takes into account for employees' tax purposes. The company contributes the same amount to the medical aid fund.

The company provides all their employees with entertainment and travel allowances.

- Thandi receives an entertainment allowance of R2 500 per month. She is required to account to the company for all her expenditure. However, she discovered that all the invoices she had kept throughout the year had been thrown away during a house cleaning before being submitted to Central. Even though Thandi was not able to prove the above invoiced amounts, she refunded R10 920 to the company, evenly over the course of the year of assessment.
- Thandi has a R2 000 a month travel allowance and has accurately calculated that 60% was used for private travel. This figure was obtained from a breakdown of her logbook.

In December 2013 the company decided to pay employees their annual bonuses. Thandi received a bonus of R80 000.

From January 2014, Thandi was given permission to use one of the company's Segways on weekends. Segways are two-wheel electronic personal transporters that are not classified as motor vehicles. The cost to Central when they were bought was R8 000 each, while the market value was R8 500. In January 2014, the cost of a new Segway was R6 000. Thandi paid Central R50 per month for the use thereof.

Fixed Property – Flat

Thandi saw a lucrative business opportunity arise when speaking to an estate agent friend. Thandi was told about a great deal about to go on the market: a two bedroom flat in Newlands was being sold for R550 000. In order to finance this purchase, Thandi entered into a loan agreement with Investing Bank Ltd. Central helped Thandi negotiate the loan agreement, which stated that interest was payable at prime plus one percent. Central does not pay any portion of the interest owing by Thandi.

The following are the interest rates applicable throughout the 2013 and 2014 years of assessment:

Interest Rate	1 March 2012 – 30 June 2013	1 July 2013 – 28 February 2014
Prime interest rate	7% p.a.	8% p.a.
Official interest rate	7.5% p.a.	7.5% p.a.

The flat was purchased on 1 July 2012, the same date on which the loan was obtained. It had to be renovated at a cost of R50 000, which Thandi was able to pay in cash. The flat was finally complete and let out to

students at R7 500 a month from 1 April 2013. Renting is not considered a process of manufacture by the South African Revenue Service ('SARS').

Invention

While on holiday back in Namibia during February 2013, Thandi invented a type of waterproof, breathable material that can be manufactured a lot cheaper than Goretex (the name brand that first invented this type of material in the United States of America). Thandi registered a patent immediately in Namibia on 25 February 2013 for R5 000 and also in South Africa for R9 000 when she returned home on 1 March 2013.

Due to Thandi not being able to afford to manufacture and sell the product herself, she allows other companies to use her invention in their products in return for royalty payments. During the current year of assessment, she earned royalties of R129 600 from South African companies and R80 000 from Namibian companies. Both amounts were earned evenly over the year.

Other income and expenditure

Thandi received the following from investments in respect of the year of assessment ended 28 February 2014 (earned evenly over the year):

Annuity from a South African trust	R18 000 (**note 1**)
South African interest	R23 000
Namibian dividends	R3 200

Note 1: The annuity consists of 60% interest and the remainder as dividends.

Thandi also independently contributes R290 per month to a South African retirement annuity fund (which Central does not take into account for employees tax purposes).

She incurred additional medical expenses, of which Central has no knowledge, to the sum of R21 000 for the 2014 year of assessment.

Additional Information

Thandi submitted both her first and second provisional tax payments on time. She estimated for her first provisional tax payment that she would earn roughly R350 000 in total for the 2014 tax year.

The following table specifies when the last three years' assessments were received back from SARS, the taxable income reflected in those assessments and whether or not that taxable income included any taxable capital gains (i.e. the amounts included in the calculation of taxable income).

Assessment	Date Received	Taxable Income	Taxable Capital Gain
2011 Assessment	15 March 2013	R290 000	R25 000
2012 Assessment	5 September 2013	R302 000	R15 000
2013 Assessment	31 January 2014	R320 000	none

YOU ARE REQUIRED TO:

1. Explain briefly why Thandi Gatso is an "employee" in terms of the Income Tax Act No. 58 of 1962. **(2 marks)**

2.
   a) Calculate the 'remuneration', as defined, for Thandi Gatso for December 2013. **(4 marks)**

   b) Determine the 'balance of remuneration' for December 2013. **(2 marks)**

c) Determine the total employees' tax to be withheld by Central (Pty) Ltd in December 2013.
  - Your solution must include, but not be limited to, a calculation breakdown of the employees' tax related to the bonus received by Thandi Gatso. **(8 marks)**

d) Determine the employees' tax to be withheld by Central (Pty) Ltd for the year of assessment ended 28 February 2014. **(5 marks)**

3. Explain, in detail, whether or not the acquisition price of the flat of R550 000 is deductible in terms of the Income Tax Act No. 58 of 1962. **(8 marks)**

4. Explain the income tax effects of Thandi Gatso's invention in terms of the Income Tax Act No. 58 of 1962. **(6 marks)**

5.

a) Explain why Thandi Gatso is a provisional taxpayer. **(3 marks)**

b) Indicate by what date Thandi Gatso is required to make her first provisional tax payment. **(1 mark)**

c) Calculate the first provisional tax payment made by Thandi Gatso. **(4 marks)**

d) Determine the taxable income of Thandi Gatso for the year of assessment ended 28 February 2014.
  - Your solution must also include an explanation for any items mentioned in the scenario of the question above that you have specifically excluded from your calculation.
  - Your solution must clearly indicate a gross income subtotal, an income subtotal and taxable income.

Gross income	7 marks
Income	3 marks
Taxable Income	11 marks

(21 marks)

e) Determine the second provisional tax payment made (in accordance with the Income Tax Act No. 58 of 1962) by Thandi Gatso for the year of assessment ended 28 February 2014. Assume Thandi could accurately determine her taxable income at the end of February 2014, i.e. the figure from 5(e) above. **(4 marks)**

f) Calculate the tax liability or tax refund with respect to Thandi Gatso's tax affairs for the tax year ended 28 February 2014. **(4 marks)**

Overall: Presentation, Logic, Clarity and Neatness **(3 marks)**

3.10.2 THANDI GATSO – SUGGESTED SOLUTION

1) An employee is a person, other than a company, **1**
who receives remuneration **1**

2)

a) Remuneration for December

Salary		22 000	**0.5**
Medical aid contributions by employer - fringe benefit		1 900	**1**
Entertainment allowance	R2 500 - (R10 920 / 12)	1 590	**1**
Travel allowance	80% of R2 000	1 600	**1**
Bonus		80 000	**0.5**

			107 090	
b)	<u>Balance of Remuneration</u>			
	Remuneration		107 090	0.5
	less s11(k) - no deduction for provident fund		0	0.5
	s18 medical deduction - none as under 65		0	1
			107 090	
c)	<u>Employees' tax for December</u>			
	Annual equivalent excluding bonus	(107 090 - 80 000) x 12 =	325 080	1
	Tax per tables = R53 096 + [30% x (R325 080 - R258 750)]		72 995	
	Less Rebate		(12 080)	
	Less Medical Rebate	(242+242+162) x 12	(7 752)	
	Total employees tax		53 163	2
	Employees' tax for December (x1/12)		4 430	1
	Annual equivalent including bonus	R325 080 + R80 000	405 080	1
	Tax per tables = R82 904 + [35% x (R405 080 - R358 110)]		99 344	
	Less Rebate		(12 080)	
	Less Medical Rebate		(7 752)	
	Total employees tax on annual equivalent (including bonus)		79 512	2
	Employees tax on annual equivalent (excluding bonus)		53 163	
	Employees tax on the bonus (R79 512 - R53 163)		26 349	0.5
	Total employees tax withheld in December = R26 349 + R4 430		30 779	0.5
d)	<u>Total employees' tax for the year</u>			
	Employees' tax up till November = R4 430 x 9 months		39 870	0.5
	Employees' tax for December		30 779	0.5

Employees' tax for January and February				
Balance of Remuneration (excluding bonus)	107 090 - 80 000	27 090		1
Use of Segway - 15% x (lower cost / MV) per annum	15% x 6k x 1/12	75		
less amount paid by Thandi		(50)		1
		27 115		
Annual equivalent	x12 =	325 380		0.5
Tax per tables = R53 096 + [30% x (R325 380 - R258 750)]		73 085		
Less Rebate		(12 080)		
Less Medical Rebate		(7 752)		
Employees tax		53 253		1
- for 2 months (x2/12)			8 876	0.5

Total Employees' Tax	79 525	

3) In order for an amount to be deductible, it must fall under either a special deduction or the general deduction formula. **1**

In this scenario, there is no special deduction under which the R550 000 falls. **0.5**

In the preamble (or beginning part) of s11, it requires the taxpayer to be carrying on a trade - Thandi is earning rental income (an activity included in the definition of trade). **1**

s11(a) requires the following:

> Expenditure or loss - The R550 000 that Thandi has paid for the flat. **1**

> Actually incurred - Thandi has already settled with the seller (i.e. paid out). **1**

> In the production of income - The flat is being purchased in order to earn rental income. **1**

> not of a capital nature

- the flat being purchased is creating an income earning structure (the flat is earning rentals). **1**
- the flat is creating an enduring benefit (being the ability to earn rentals in the future. **1**

Therefore the expenditure is of a capital nature. **0.5**

Hence it is submitted that R550 000 would NOT be deductible due to the cost being capital in nature. **1**

max 8

4) Thandi is a non-resident, and will be taxed on SA source income **1**

s9 deals with amounts that are from an SA source or not from an SA source **1**

In terms of s9(2)(d), the use of the invention in South Africa means that the royalties received for the use thereof is from a South African source. **1**

and hence R129 600 will be included in gross income **1**

Because the royalties are from a South African source, a s35 withholdings tax of 12% is applied to this income *(s49B at 12% after 1 July 2013).* **1**

R129 600 x 12% = R15 552 will be withheld and paid over to SARS.

Due to the s35 withholdings tax applying (and because the withholdings tax is a final tax), s10(1)(l) applies to exempt this income from further tax. **1**

Therefore R129 600 will be exempt.

The registration costs of R9 000 should be deductible under s11(gB) **1**

However, as the costs are incurred in order to earn exempt income, the deduction is disallowed under s23(f). **1**

max 6

5)

a) Thandi is under the age of 65 **1**

and earns income from a business and taxable income is in excess of the tax threshold **1**

and taxable income from both interest and dividends exceed R20 000 **1**

b) 31 August 2013 **1**

c) First provisional tax payment

Taxable income estimate - R290 000 - R25 000 basic x 1.24	328 600	**1**
Being the 2011 assessment (as the basic amount) scaled up by 8% per annum for 3 years		
Tax per tables = R53 096 + [30% x (R328 600 - R258 750)]	74 051	
Less Rebate	(12 080)	
Less Medical Rebate	(7 752)	

Normal tax on basic			54 219	1
First 6 months owing: R54 219 / 2			27 110	1
less employees' tax for first 6 months: R4 430 x 6			(26 580)	1
First provisional tax payment			530	

d) <u>Taxable income</u>

Gross income				
Salary			264 000	0.5
Medical aid contribution by employer - fringe benefit			22 800	0.5
Bonus			80 000	0.5
Fringe benefit - Use of Segway (from 2(e) above)	R25 x 2		50	1
Rent income			82 500	1
Royalties – SA source	= 129 600		129 600	1
Royalties - Namibia - not SA source			0	1
Annuity	= 18 000		18 000	0.5
SA interest	= 23 000		23 000	0.5
Namibian Dividends - not SA source			0	0.5
		Gross income	**619 950**	
less exemptions				
s10(1)(h) non-res interest exemption n/a as in SA for > 183 days			0	1
s10(1)(l) withholdings tax income exemption			(129 600)	1
s10(1)(i) interest exemption	18000x60%=	10 800		1
		23 000		
limited to R22 800			(22 800)	
(s10(2)(b) prohibits exemptions under s10(1)(h) and (k))				1
		Income	467 550	
less deductions				
s11(k) - no deduction for provident fund			0	0.5
s11A - pre-trade interest (rental a new trade)		550k x 8% x 273/365	(32 910)	1
s24J - interest once asset is being used		550k x 8% x 91/365	(10 970)	1
		550k x 9% x 243/365	(32 955)	1
s11(gB) - registration of patent - disallowed as exempt income			0	1
s13(1) - building - no deduction as not used in a process of manufacture			0	0.5
s13(quin) - building - no deduction as residential accommodation			0	0.5
Taxable income before s11(n) RAF deduction			390 716	
less s11(n) RAF deduction (R290 x 12)		3 480		
Limited to the greater of:				
R 1 750	1 750			
R3 500 - R0 (current pension contribution) =	3 500			
15% x (R390 716 - R264 000)	19 007			1
Therefore s11(n) RAF deduction is			(3 480)	1
Taxable income before s18 medical deduction			387 236	

	add allowances				
	travel allowance	Total	24 000		
		Business portion	(9 600)	14 400	1
	entertainment allowance	Total	30 000		
		refunded	(10 920)	19 080	1
				420 716	
	s18 medical deduction (all deductible as disabled dependent)				
	- medical aid		22 800		0.5
	- employer contribution (deemed to be by employee)		22 800		0.5
	- reduced by 4 times medical rebate (230+230+154) x 12		(29 472)		
	- additional medical expenses		21 000	(37 128)	0.5
	Taxable Income			383 588	*
e)	Second provisional tax payment				
	Lower of: Basic amount	320 000			
	and estimate (use actual)	383 588			1
	Tax per tables on basic = R53 096 + [30% x (R320 000 - R258 750)]			71 471	
	Less Rebate			(12 080)	
	Less Medical Rebate			(7 752)	
	Normal tax on basic			51 639	1
	less first provisional payment			(530)	0.5
	less total employees' tax for the year			(79 525)	0.5
				(28 416)	
	Therefore second payment =			0	1
f)	Tax liability / refund				
	Taxable Income			383 588	0.5
	Tax per tables on basic = R82 904 + [35% x (R383 588 - R358 110)]			91 821	
	Less Rebate			(12 080)	
	Less Medical Rebate			(7 752)	
	Normal tax on basic			71 989	1
	less total employees' tax for the year			(79 252)	0.5
	less total provisional tax payments			(530)	0.5
	Normal tax refund due from SARS			(7 793)	0.5
	s35 Withholdings Tax	R129 600 x 12%		15 552	1
OVERALL:		neatness, coherence, logic, presentation			3