

**1 Introduction**

Industrial Generator Solutions (Pty) Ltd ('IGS') is a company based in South Africa that manufactures and supplies industrial generators, inverters and more recently photovoltaic systems (solar systems) to a variety of customers across South Africa. IGS recognised the rising costs of diesel in South Africa and accordingly expanded its product offerings during its 2021 financial year to include solar systems.

IGS is a 'small business corporation' as defined in section 12E(4)(a) of the Income Tax Act. It is registered as a category B value-added tax (VAT) vendor, is registered for e-filing and makes 96% taxable supplies as determined in terms of the turnover-based method in Binding General Ruling No. 16. All suppliers of IGS are registered VAT vendors, except where specifically stated otherwise. All relevant and valid documentation as required in terms of the VAT Act has been obtained.

IGS is the holding company in the Industrial Generator Solutions (Pty) Ltd Group ('IGS Group'). The IGS Group is in the process of finalising its separate and consolidated financial statements for the financial year ended 31 December 2023 (FY2023). All the companies in the IGS Group have the same financial year end.

During FY2021, IGS acquired an 80% controlling interest in Lithium Efficient Batteries (Pty) Ltd ('LE Batteries'), a company specialising in the manufacture of lithium batteries and silicon cells used within solar system solutions. The acquisition of this interest met the definition of a business combination in accordance with IFRS 3 *Business Combinations*.

**2 Transaction with LE Batteries**

During FY2021, IGS was approached by LE Batteries with a proposal to install an industrial specialised machine that manufactures silicon cells. The machine would be installed at the production plant of LE Batteries and help LE Batteries to meet the demand for silicon cells in view of the continued increase in fuel prices and the energy crisis experienced in South Africa. Initially, LE Batteries leased the industrial specialised machine for two months from an unrelated third party, Energy for Living (Pty) Ltd ('EFL'). EFL went into liquidation and could no longer continue to lease the machine to LE Batteries but proposed that it sell the machine to LE Batteries for a market-related price of R10 million (including VAT).

LE Batteries made the proposal to IGS because it did not have the cash to finance the acquisition and installation of the machine.

IGS agreed and on 1 January 2022 IGS purchased the industrial specialised machine that manufactures silicon cells from EFL. The machine was available for use as intended by management at the production plant of LE Batteries on 1 January 2022.

IGS also entered into an agreement related to the specialised machine with LE Batteries. The agreement is an 'instalment credit agreement' as contemplated in para. (b) of the definition of 'instalment credit agreement' of section 1 of the VAT Act and contains the following terms and conditions:

- 1.1 LE Batteries has the right to use the machine for a period of ten years, effective from 1 January 2022, in exchange for market-related monthly payments of R140 000 (including VAT), payable in arrears.

- 1.2 LE Batteries is to use WeService (Pty) Ltd ('WeService') for any service, repairs and maintenance of the industrial specialised machine for the duration of the ten-year period. WeService is an unrelated third-party service provider.
- 1.3 IGS is not allowed to exchange or substitute any of the components (e.g., laser cutter, gears, fasteners) of the machine during the period of use unless these components become faulty or malfunction for whatever reason during the duration of the ten-year period. If the parts become faulty or malfunction, IGS must source the replacements from or substitute the components with components from WeService.
- 1.4 LE Batteries is only allowed to use the machine for its primary business activities at the production plant to manufacture silicon cells and neither IGS nor LE Batteries has the right to change the purpose for which the machine is used during the ten-year period.
- 1.5 Ownership of the industrial specialised machine will not transfer to LE Batteries at the end of the lease term.

The total invoice received by IGS for the purchase of this machine amounted to R10 million (including VAT). This was equal to the fair market value of this machine. The 'cash value' of the machine equates to the fair market value and the open market value. The machine is regarded to have a useful life of 12 years with an insignificant residual value.

On 1 January 2022, IGS and LE Batteries settled the legal fees related to this lease agreement, which amounted to a total of R25 000 (including VAT), on a 50 : 50 basis.

### **3 Solar systems service technicians**

To assist with the increasing demand for installation of solar systems, IGS entered into registered learnership agreements with two of its employees (who are not VAT vendors) on 1 October 2023. The learnership agreements are for a period of five years. One of the two employees is a person with a disability as defined in section 6B(1) of the Income Tax Act. Both employees are in possession of a solar system service technician NQF Level 5 qualification. The total salary paid to these employees for the year of assessment ended 31 December 2023 amounted to R95 000 per employee.

Given the high industry requirements that technicians should stay up to date with their continuing professional development, IGS entered into a 24-month subscription contract with an independent third party, GlobalTech Training (Pty) Ltd ('GlobalTech'), to provide monthly training and industry update sessions to these two employees and other employees of IGS. On 1 October 2023, IGS paid an amount of R350 000 (excluding VAT) to GlobalTech for monthly training and industry update services to be provided during the period 1 October 2023 to 30 September 2024.

### **4 Additional information**

- All property, plant and equipment items are accounted for on the cost model in accordance with IAS 16 *Property, Plant and Equipment* by all the companies in the IGS Group.
- All initial useful life and other estimates remain unchanged unless otherwise stated.
- None of the companies in the IGS Group has elected any of the recognition exemptions in IFRS 16 *Leases*, para. 5, to account for any lease agreements.
- Any right-of-use assets are presented separately in the statement of financial position.
- IGS will make use of all possible tax benefits and will therefore elect any option available to it in terms of the Income Tax Act that will minimise or defer its normal tax liability.

- IGS submitted an application to the South African Revenue Service to apply for a write-off period on the industrial specialised machine as the machine does not appear in the annexure to Binding General Ruling No. 7 in Interpretation Note 47. The Commissioner accepted the application with the supporting documents and motivation and agreed to allow a ten-year period on the straight-line method, in terms of section 11(e) of the Income Tax Act.

**INITIAL TEST OF COMPETENCE, JANUARY 2024**

**PROFESSIONAL PAPER 4**

**This paper consists of two questions.  
Answer each question in a separate answer book.**

<b>PAPER 4 QUESTION 2 – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(a)	Briefly discuss whether the agreement between IGS and LE Batteries contains a lease as defined in accordance with IFRS 16.  <i>Communication skills – clarity of expression</i>	10  1	  11
(b)	Prepare the pro forma consolidation journal entry(entries) required to account for the intragroup lease transaction between IGS and LE Batteries in the consolidated financial statements of the IGS Group for FY2023.  <ul style="list-style-type: none"> <li>• Ignore all forms of taxation, including VAT.</li> <li>• Ignore any non-controlling interest(s).</li> <li>• Journal narrations are not required.</li> <li>• Assume that the agreement between IGS and LE Batteries contains a lease, and that it should be classified as a finance lease, as defined in accordance with IFRS 16, in the separate financial statements of IGS.</li> </ul> <i>Communication skills – presentation</i>	18  1	  19
(c)	Discuss, supported with calculations, the normal tax consequences for IGS of the letting of the industrial specialised machine to LE Batteries for the year of assessment ended 31 December 2023.  <ul style="list-style-type: none"> <li>• Do not discuss the related legal fees.</li> </ul> <i>Communication skills – layout and structure</i>	11  1	  12
(d)	Calculate, supported with brief reasons, the impact of part 3 of the scenario (the solar systems service technicians) on the taxable income of IGS for the year of assessment ended 31 December 2023.	8	8
<b>Total for question 2</b>			<b>50</b>
<b>TOTAL FOR PAPER 4</b>			<b>100</b>