QUESTION 1 **100 marks**

You are employed by Confused (Pty) Ltd ('Confused'). Confused provides accounting and tax consulting services to various clients. Your portfolio includes the following two allocated clients who have approached you regarding the matters below.

Client 1: Makhado Textiles Ltd

Ignore value-added tax (VAT) for client 1

Makhado Textiles Ltd ('Makhado') is the holding company of a group of companies and is listed on the Johannesburg Stock Exchange. The Makhado group's primary business is textile production. The financial year end and year of assessment for all the companies in the Makhado group is 30 June. The functional currency of Makhado is the South African rand (ZAR).

On 1 July 2014 Makhado subscribed for an 80% controlling interest in the issued share capital of a company newly formed in South Africa, Shweshwe Fabrics (Pty) Ltd ('Shweshwe'). Shweshwe's main business is the manufacture of material with traditional African prints for the fashion industry. Shweshwe purchased land near Mapungubwe following the decision by the Board of Directors to construct a factory building to house its spinning mill and packing facility.

On 1 August 2014 Makhado borrowed ZAR20 million at 8% per annum from a local bank and on the same date lent the full amount to Shweshwe at 10% per annum to finance the construction of the factory building. The capital amount of the loan will be repaid in 2024.

Client 2: Jali group

All amounts exclude VAT unless stated otherwise for client 2

The holding company of the group, Jali Ltd ('Jali'), was incorporated in the Republic of South Africa (RSA) on 1 January 2010 and subsequently listed on the Johannesburg Stock Exchange. Jali manufactures solar panels. The functional currency of Jali is the South African rand (ZAR). All companies in the Jali group have a 31 December financial year end and year of assessment. The group has two subsidiaries, which were wholly owned by Jali at the start of the financial year ended 31 December 2017 (FY2017):

- *Kekana (Pty) Ltd ('Kekana'):* Kekana is incorporated and effectively managed in the RSA. The functional currency of Kekana is the ZAR; and
- *Kermit Inc. ('Kermit'):* Kermit is incorporated and is effectively managed in the United States of America (USA). The functional currency of Kermit is the United States dollar (USD).

Background information on Kekana

Kekana was incorporated as a subsidiary of Jali on 1 January 2016 to manufacture more affordable solar panels for domestic use, while Jali itself would concentrate on the manufacture of solar panels for industrial use. Jali and Kekana are Category B VAT vendors. The Commissioner of the South African Revenue Service regards the manufacture of solar panels and related products as a process of manufacture.

On the incorporation of Kekana, Jali transferred an office building and trading stock to Kekana in exchange for 230 000 Kekana shares. The provisions of section 42 of the *Income Tax Act,* 1962 (Act 58 of 1962), as amended, ('the Act') applied to this transaction.

The following details relate to the office building that was transferred to Kekana. The office building –

- was constructed by Jali at a cost of ZAR30 million;
- was brought into use by Jali on 1 January 2010 with an expected useful life of ten years with no residual value; and
- had a fair value and market value of ZAR30 million at the transfer date, with an expected useful life of eight years with no residual value.

The following details relate to the trading stock that was transferred to Kekana. The trading stock –

- had a fair value and market value of ZAR3 million at the transfer date;
- was manufactured by Jali at a cost of ZAR2 million; and
- was sold by Kekana during the 2016 year of assessment for ZAR3 500 000.

On 1 January 2016 Jali also subscribed for 770 000 additional shares in Kekana at ZAR100 each to fund Kekana's operations.

Purchase of new machinery by Kekana

At the Kekana Board of Directors' meeting held on 1 February 2017, the directors passed a resolution to focus the operations on the manufacture of solar-powered water pumps. The Commissioner of the South African Revenue Service regards the manufacture of solar-powered water pumps as a process similar to a process of manufacture. The directors also decided to purchase all the machinery necessary for this new operation and to hedge any foreign exchange exposure resulting from the purchase.

On 1 March 2017 Kekana placed an order for the new machinery with Zungu Power Solutions ('Zungu'), a non-resident company trading in Saudi Arabia, for USD15 000. Because the purchase of this machinery is routinely denominated in USD, the contract does not give rise to an embedded derivative. Zungu has never been a connected person in relation to Kekana. The purchase price included a charge of USD1 000 for installing and testing the machinery. Installing and testing the machinery was regarded as an integral part of the delivery of the machinery. On placing the order, Kekana paid a non-refundable deposit of USD4 500 to Zungu. The machinery was expected to be delivered on 1 May 2017 on Zungu's usual settlement terms. The balance owing was payable on 30 June 2017 and was settled on that date.

The machinery was delivered and control of the machinery passed to Kekana on 1 May 2017. Kekana used a clearing agent for this transaction. The customs duty value of the machinery was ZAR210 000. Import duties of ZAR19 000 were paid on the machinery on 10 May 2017.

During May 2017 Kekana incurred raw material and labour costs totalling ZAR25 000 in testing the new machinery (including the solar-powered water pumps donated – see next par.) and Kekana's marketing division spent ZAR30 000 on the development of a website and video presentation to promote the solar-powered water pumps. The machinery was ready for its intended use on 1 June 2017, after the completion of the installation and testing procedures performed by the Zungu personnel.

Solar-powered water pumps were donated to a registered public benefit organisation on 26 May 2017. The solar-powered water pumps cost Kekana ZAR5 000 to manufacture during the testing period and have a market value of ZAR7 500. Kekana made no other donations during the 2017 year of assessment and has no unutilised donation deductions in terms of s18A of the Act from the previous years of assessment.

Manufacture of the new solar-powered water pumps commenced on 1 July 2017. The expected useful life of the machinery is eight years from the date at which depreciation commences for financial reporting purposes with no residual value.

On 1 March 2017 Kekana entered into a forward exchange contract (FEC) to purchase USD10 500 on 30 June 2017. On this date the FEC was designated, in its entirety, as a hedging instrument in respect of the foreign firm commitment to purchase the new machinery (hedged item). This hedge was designated as a cash flow hedge of foreign exchange risk. This hedge relationship met all requirements as indicated in IFRS 9 *Financial Instruments,* par. 6.4.1, for the duration of the hedging relationship.

Loan from Kermit

Kekana borrowed USD8 000 from Kermit on 1 May 2017 at an effective interest rate of 1% per annum. The interest is payable annually starting from the end of April 2018. The capital amount of the loan is repayable in full on 30 April 2022. This transaction complied with all the relevant laws and regulations and was conducted at arm's length.

Sale of office building purchased from Jali by Kekana

On 1 October 2017 Kekana sold the office building acquired on its incorporation from Jali for ZAR10 million to an unrelated person.

Sale of shares in Kekana by Jali

On 1 November 2017 Jali sold the 230 000 shares (that it had received on the transfer of the office building and trading stock to Kekana on 1 January 2016), for ZAR12 million to a person who is not a connected person in relation to Jali. Jali sold these shares as it needed additional funding.

Additional information

- The following exchange rates are applicable for the period from 1 March to 31 December 2017:

Date	**Spot rate**	**Forward rate**	
	USD:ZAR	**USD:ZAR**	
1 March 2017	13,12	13,43	Four-month FEC
1 May 2017	13,27	13,56	Two-month FEC
		13,72	Four-month FEC
1 June 2017	13,46	13,80	One-month FEC
		13,91	Four-month FEC
30 June 2017	13,75	13,30	Four-month FEC
31 December 2017	13,62		
Average exchange rate for the period 1 May 2017 to 31 December 2017			13,45

- The only temporary difference of Kekana that existed at 31 December 2016 was that relating to the office building acquired from Jali on 1 January 2016.
- The Jali group of companies applies International Financial Reporting Standards (IFRS).
- The Jali group of companies have early adopted IFRS 9 *Financial Instruments,* including chapter 6 on hedge accounting.
- Round all amounts to the nearest ZAR.
- All amounts are material.

MONETARY CHANGES – ITC 2018

Applicable in respect of years of assessment commencing **on or after 1 March 2016 (i.e. 2017 year of assessment)** – *unless specifically stated otherwise*

REBATES (section 6)

Primary rebate increases from R13 257 to **R13 500**;

(Secondary and tertiary rebates remained unchanged)

MEDICAL REBATES (section 6A)

Benefits to the taxpayer: R270 increases to **R286**;
Benefits to the taxpayer and one dependant: R540 increases to **R572;**
Benefits to each additional dependant: R181 increases to **R192**.

SECTION 9D inclusion adjustment if the resident is a natural person (section 9D(2A)(f))

For purposes of paragraph 10 of the Eighth Schedule: 33,3% increases to **40%** of that company's net capital gain for the relevant foreign tax year if the resident is a natural person.

SECTION 10(1)(q)(ii) Scholarship or bursary to relative of employee exemption

(*aa*) Remuneration proxy: R250 000 increases to **R400 000**
(*bb*)(A): R10 000 increases to **R15 000**
(*bb*)(B): R30 000 increases to **R40 000**

RESIDENTIAL ACCOMMODATION (paragraph 9 of the Seventh Schedule)

Symbol B of R73 650 increases to **R75 000**.

CGT ANNUAL EXCLUSION (paragraph 5(1) of the Eighth Schedule)

R30 000 increases to **R40 000**

CGT INCLUSION RATES (paragraph 10 of the Eighth Schedule)

In the case of a natural person or a special trust (as defined in s1): 33,3% increases to **40%**
In the case of a company and a trust (not being a special trust): 66,6% increases to **80%**

RATES OF NORMAL TAX

- In respect of the taxable income (excluding any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit or severance benefit) of natural persons, estates and special trusts

Taxable Income (R)	**Rate of Tax**
0 – 188 000	18% of taxable income
188 001 – 293 600	R33 840 + 26% of the amount above R188 000
293 601 – 406 400	R61 269 + 31% of the amount above R293 600
406 401 – 550 100	R96 264 + 36% of the amount above R406 400
550 101– 701 300	R147 996 + 39% of the amount above R550 100
701 301 and above	R206 964 + 41% of the amount above R701 300

- **Small Business Corporation (as defined in section 12E)**
  (Applicable in respect of years of assessment ending on or after 1 April 2016)

Taxable Income	**Rate of Tax**
0 – 75 000	0% of taxable income
75 001 – 365 000	7% of the amount above R75 000
365 001 – 550 000	R20 300 + 21% of the amount above R365 000
550 001 and above	R59 150 + 28% of the amount above R550 000

TRAVEL ALLOWANCE

Value of the vehicle (R)	Fixed cost (R p.a.)	Fuel cost (c/km)	Maintenance cost (c/km)
0 – 80 000	26 675	82.4	30.8
80 001 – 160 000	47 644	92.0	38.6
160 001 – 240 000	68 684	100.0	42.5
240 001 – 320 000	87 223	107.5	46.4
320 001 – 400 000	105 822	115.0	54.5
400 001 – 480 000	125 303	132.0	64.0
480 001 – 560 000	144 784	136.5	79.5
Exceeding 560 000	144 784	136.5	79.5

Alternative fixed rate for certain reimbursive travel allowances: **329** cents per kilometer (previously 318 cents)

SUBSISTENCE ALLOWANCE

- Local travel:
  - Allowance for incidental costs only – **R115** (previously R109) for each day.
  - Allowance for meals and incidental costs – **R372** (previously R353) for each day.
- Overseas travel:
  - Actual accommodation plus a prescribed amount based on the relevant country (which amount will be provided in the ITC if it differs from the amount listed in the Regulation in the SAICA Student Handbook).

TRANSFER DUTY (Section 2(1)(b) of the Transfer Duty Act)

In respect of acquisition of property on or after **1 March 2016:**

Value of property (R)	Rate
0 – 750 000	0%
750 001 – 1 250 000	3% of the value above R750 000
1 250 001 – 1 750 000	R15 000 + 6% of the value above R1 250 000
1 750 001 – 2 250 000	R45 000 + 8% of the value above R1 750 000
2 250 001 – 10 000 000	R85 000 + 11% of the value above R2 250 000
10 000 001 and above	R937 500 + 13% of the value above R10 000 000

INITIAL TEST OF COMPETENCE, JANUARY 2018
PROFESSIONAL PAPER 3

This question consists of two parts. Answer each part in a separate answer book.

QUESTION 1 PART I – REQUIRED		**Marks**	
		Sub-total	**Total**
(a)	Discuss the income tax consequences of the interest received and interest paid on both the ZAR20 million loans in Makhado's taxable income for the year of assessment ended 30 June 2017. Refer to case law and applicable legislation where relevant.	11	11
(b)	Discuss, with supporting calculations, the VAT consequences for Kekana arising from the purchase of the new machinery.	8	8
(c)	Discuss, with supporting calculations, the income tax consequences for Kekana with respect to the new machinery as well as the solar-powered water pumps for the year of assessment ended 31 December 2017.	26	26
(d)	Calculate the capital gain or loss (if any), as defined in the Eighth Schedule, for Kekana from the sale of the building for the year of assessment ended 31 December 2017.	5	5
(e)	Discuss, with supporting calculations, the income tax consequences for Jali in respect of the sale of the shares in Kekana for the year of assessment ended 31 December 2017.	5	5
(f)	Discuss the income tax consequences of the foreign exchange differences that arise on the re-measurement of the loan provided to Kekana by Kermit for the year of assessment ended 31 December 2017.	5	5
Communication skills applicable to all of the above required sections – logical argument; clarity of expression			*4*
Total for part I			**64**

INITIAL TEST OF COMPETENCE, JANUARY 2018
PROFESSIONAL PAPER 3

This question consists of two parts. Answer each part in a separate answer book.

QUESTION 1 PART II – REQUIRED		**Marks**	
		Sub-total	**Total**
(g)	Prepare the journal entries required to account for all of the transactions relating to the machinery bought from Zungu as well as the loan obtained from Kermit in the individual financial statements of Kekana for FY2017. • Ignore VAT, current taxation and deferred taxation. • Do not prepare closing journal entries.	27	
	Communication skills – presentation and layout	*1*	28
(h)	Calculate the deferred tax balances in Kekana's individual financial statements as at 31 December 2016 and 2017. For the purposes of this required only, assume as at 31 December 2017 that the tax base relating to − • the machinery bought from Zungu is ZAR200 000; and • the loan from Kermit is ZAR106 160. Ignore VAT.	8	8
Total for part II			**36**
TOTAL FOR THE QUESTION			**100**