

QUESTION 2

48 marks

All the companies referred to in the question are Category C Value-Added Tax (VAT) vendors and all amounts exclude VAT, unless specifically stated otherwise. Assume a VAT rate of 15%.

Zethu Izihlangu Ltd ('ZI') is a company registered in South Africa with its head office in Cape Town. ZI has a December year end. ZI was formed by Mr Lwazi Mhlengeni, an entrepreneur, in 1998. The company produces high-quality sports shoes for men, women and children, which are sold under the popular brand name 'Zeizi'.

ZI has a number of branches and subsidiaries that are involved in the various aspects of the business of manufacturing, distributing and retailing of the shoes. ZI buys its raw materials in South Africa, Kenya and Taiwan and the Zeizi shoes are manufactured in two factories in South Africa, both of which are owned by ZI. The Cape Town factory manufactures a range of children's shoes, under the brand name ZeiziKids, and the Durban factory manufactures men's and women's ranges of Zeizi shoes. The company distributes the finished products to all Zeizi branches located in 20 countries, including South Africa.

ZI's accountant calculated the taxable income of the company for the 2018 year of assessment to be ZAR9 740 000 before taking into account the transactions described in notes 1 to 5 below. She is unsure how to treat these transactions and has sought your advice for finalising the tax calculations.

All parties to these transactions make use of any possible elections that would legally minimise their tax liability.

The accountant sent you the following notes:

1 ZI manufacturing facilities

- 1.1 ZI entered into a lease agreement with Siyenze (Pty) Ltd ('Siyenze'), an unconnected third party, on the following terms:
- ZI leased 100m² in a building adjacent to the Cape Town factory to Siyenze for a period of ten years;
 - The lease agreement commenced on 1 December 2018;
 - Siyenze must pay ZI an initial lease premium of ZAR60 000 on 1 December 2018; and
 - Siyenze must pay ZI monthly rentals of ZAR20 000 on the first day of each month from 1 January 2019 onwards.
- 1.2 Each ZI factory has an exhibit collection in which at least one pair of every type of Zeizi shoes ever manufactured is displayed. In ZI's accounting records shoes that form part of the exhibit are transferred from finished goods to an asset account called 'exhibition assets'. On 30 November 2018 the directors of ZI decided to donate a special pair of shoes that had been manufactured during ZI's 2018 year of assessment to a non-profit organisation (which is not a public benefit organisation for income tax purposes). The shoes had been recorded in the list of exhibition assets at a cost of ZAR1 200 per pair. Their market value was ZAR3 500 per pair on 30 November 2018.
- 1.3 The administration and sales office at ZI's Cape Town factory leased a high-resolution colour printer from PH Printer World ('PH'), a local company in Cape Town. The terms of the lease agreement were as follows:
- The lease term was four years and commenced on 1 July 2014;

- Lease payments: 48 monthly payments of ZAR2 275 each, payable on the first day of every month; and
- ZI could purchase the printer from PH at the end of the lease period for ZAR1 000.

1.4 ZI used the printer in its business and the directors therefore decided to exercise the purchase option. ZI accordingly paid ZAR1 000 to PH on 1 July 2018 and took ownership of the printer. On that date the market value of the printer was ZAR12 500. The South African Revenue Service (SARS) Binding General Ruling No. 7 provides for a three-year write-off period on electronic office equipment. The remaining useful life of the printer is three years.

1.5 ZI employed 12 apprentices in its Cape Town and Durban factories. These apprentices were all learners serving a 24-month NQF level 4 learnership agreement registered with the Fibre Processing and Manufacturing Sector Education and Training Authority (FP&M SETA). These learnership agreements were entered into on 1 January 2017 and were registered by the FP&M SETA on 1 April 2017. One apprentice left ZI's employ on 1 July 2018 and did not complete the learnership. The other 11 apprentices successfully completed their learnerships on 31 December 2018.

1.6 ZI carried out an extensive refurbishment of its Durban factory during 2017 and 2018. ZI erected the original factory building in 2002 and the demand for Zeizi shoes made the refurbishment a priority to enable it to grow the business. The total cost of the refurbishment project was ZAR30 million, with the refurbishment expenditure set out as follows:

		ZAR million
Cost of repairs to the factory	Between March and July 2018	5
Extension to the factory building to increase the production capacity	Commenced: 1 November 2017 Completed and brought into use: 1 March 2018	25

The above-mentioned refurbishment project was partially funded by a loan from SA2 (see note 4).

2 ZI head office

ZI's head office is based in Constantia, Cape Town. ZI purchased the land for a total consideration of ZAR5 million from an unconnected person, who was not a registered VAT vendor, in May 2018. The company immediately commenced with the construction of the office building. The building was completed at a cost of ZAR8 million and was brought into use on 1 November 2018.

3 South African subsidiary 1: Shoeman of Africa (Pty) Ltd

ZI owns 80% of the equity shares of Shoeman of Africa (Pty) Ltd ('SA1'), which carries on a process of manufacture. SA1 had equipment that had been acquired at a cost of ZAR650 000 and was brought into use in a process of manufacture on 2 January 2018.

On 1 September 2018 SA1 sold the equipment to ZI for use in its Durban factory at its fair market value of ZAR1 290 000. ZI's Durban factory brought the equipment into use in its process of manufacture on the same date.

4 South African subsidiary 2: Shoez for Africa (Pty) Ltd

Shoez for Africa (Pty) Ltd ('SA2') is a South African tax resident with offices in Durban. The equity shares are owned as follows:

- ZI – 65%
- Lwazi Mhlengeni – 25%
- Lwazi Family Trust – 10%.

4.1 SA2 has a wholly-owned subsidiary, Ta-Chaussure Ltd ('TAC'), which is registered and based in Mauritius. Although TAC is wholly owned by a South African resident company, TAC has a foreign business establishment in Mauritius and accordingly section 9D of the *Income Tax Act*, Act 58 of 1962, is not applicable. On 1 December 2017 TAC advanced a loan denominated in United States dollar of USD2,5 million to ZI to fund the cost of extending its Durban factory. The loan agreement provided for interest at the rate of 15% per annum, payable at the end of each financial year. The capital is repayable in full at maturity. All interest payments were up to date, but the full capital amount was still outstanding as at 31 December 2018. SARS considers the ratio of debt to equity to be acceptable and that the market-related interest rate on a USD-denominated loan originating in Mauritius would be 4% over the whole period.

The exchange rates between the United States dollar (USD) and South African rand (ZAR) over the period of the loan were as follows:

	USD1 : ZAR
Spot rate	
1 December 2017	13,0000
31 December 2017	12,3000
31 December 2018	13,9000
Average exchange rate for the year ended	
31 December 2017	13,3129
31 December 2018	13,0000

4.2 On 1 June 2018, SA2 sold a delivery vehicle to ZI for use in its Cape Town factory. SA2 originally acquired the delivery vehicle at a cost of ZAR450 000 on 1 September 2016 and brought the vehicle into use on the same day. SA2 sold the vehicle to ZI for ZAR400 000 on 1 June 2018. The market value of the vehicle was ZAR300 000. The SARS Binding General Ruling No. 7 provides for a four-year write-off period on delivery vehicles. The remaining useful life of the vehicle is four years.

5 Mauritian branch

ZI has a branch in Port Louis, Mauritius, which imports Zeizi shoes from companies in the ZI group and sells the shoes in Mauritius. The Mauritian branch also distributes Zeizi shoes to customers, who are unconnected persons in relation to the ZI group, in Australasia and South America. ZI's Mauritian branch operates from rented premises in Port Louis. The functional currency of Mauritius is the Mauritian Rupee (MUR). SARS is satisfied that all transactions between the Mauritian branch and connected persons have been carried out at arm's-length market values.

The results of the Mauritian branch's business activities for the 2018 financial year (FY2018) were as follows:

	MUR
Sales	35 000 000
Less: Cost of sales	(19 250 000)
Gross profit	15 750 000
Less: Other expenses (all deductible in terms of Mauritian and South African tax law)	(9 750 000)
Net income	6 000 000

All income and expenses accrue evenly during the year.

The exchange rates between the ZAR and MUR during FY2018 were as follows:

	MUR1 : ZAR
Spot rate	
31 December 2017	0,3654
31 December 2018	0,4000
Average exchange rate for the year ended	
31 December 2017	0,3720
31 December 2018	0,3875

EXTRACT FROM THE
AGREEMENT BETWEEN THE GOVERNMENT OF THE REPUBLIC OF SOUTH AFRICA
AND THE GOVERNMENT OF THE REPUBLIC OF MAURITIUS FOR THE AVOIDANCE
OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT
TO TAXES ON INCOME

The Convention was published in *Government Gazette* No 471 dated 17 June 2005.

Article 1
Persons Covered

This Agreement shall apply to persons who are residents of one or both of the Contracting States.

Article 2
Taxes Covered

1. This Agreement shall apply to taxes on income imposed on behalf of a Contracting State or its political subdivisions, irrespective of the manner in which they are levied.
2. There shall be regarded as taxes on income all taxes imposed on total income or on elements of income, including taxes on gains from the alienation of movable or immovable property.
3. The existing taxes to which this Agreement shall apply are:
 - (a) in Mauritius, the income tax:
(hereinafter referred to as “Mauritius tax”); and
 - (b) in South Africa—
 - (i) the normal tax;
 - (ii) the secondary tax on companies;
 - (iii) the withholding tax on royalties; and
 - (iv) the tax on foreign entertainers and sportspersons;
(hereinafter referred to as “South African tax”).
4. The Agreement shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Agreement in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.

Article 3
General Definitions

1. In this Agreement, unless the context otherwise requires—
 - (a) the term “Mauritius” means the Republic of Mauritius and includes—
 - (i) all the territories and islands which, in accordance with the laws of Mauritius, constitute the State of Mauritius;
 - (ii) the territorial sea of Mauritius; and
 - (iii) any area outside the territorial sea of Mauritius which in accordance with international law has been or may hereafter be designated, under the laws of Mauritius, as an area, including the Continental Shelf, within which the rights of Mauritius with respect to the sea, the sea bed and sub-soil and their natural resources may be exercised;
 - (b) the term “South Africa” means the Republic of South Africa and, when used in a geographical sense, includes the territorial sea thereof as well as any area outside the territorial sea, including the continental shelf, which has been or may hereafter be

- designated, under the laws of South Africa and in accordance with international law, as an area within which South Africa may exercise sovereign rights or jurisdiction;
- (c) the terms “a Contracting State” and “the other Contracting State” mean Mauritius or South Africa as the context requires;
 - (d) the term “business” includes the performance of professional services and of other activities of an independent character;
 - (e) the term “company” means any body corporate or any entity which is treated as a company or body corporate for tax purposes; (f) the term “competent authority” means—
 - (i) in Mauritius, the Director General of the Mauritius Revenue Authority or an authorised representative of the Director General; and
 - (ii) in South Africa, the Commissioner for the South African Revenue Service or an authorised representative of the Commissioner;
 - ...
 - (g) the term “enterprise” applies to the carrying on of any business;
 - (h) the terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
 - (i) the term “international traffic” means any transport by a ship or aircraft operated by an enterprise of a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;
 - (j) the term “national”, in relation to a Contracting State, means—
 - (i) any individual possessing the nationality or citizenship of that Contracting State; and
 - (ii) any legal person or association deriving its status as such from the laws in force in that Contracting State;
 - (k) the term “person” includes an individual, a company and any other body of persons which is treated as an entity for tax purposes; and
 - (l) the term “tax” means Mauritius tax or South African tax, as the context requires.
2. As regards the application of the Agreement at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Agreement applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Article 4 **Resident**

1. For the purposes of this Agreement, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of that person’s domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State.
2. Where by reason of the provisions of paragraph 1 of this Article an individual is a resident of both Contracting States, then that individual’s status shall be determined as follows—
 - (a) the individual shall be deemed to be a resident of the State in which a permanent home is available to the individual, if a permanent home is available to the individual in both States, the individual shall be deemed to be a resident only of the State with which the individual’s personal and economic relations are closer (centre of vital interests);
 - (b) if the State in which the centre of vital interests is situated cannot be determined, or if the individual does not have a permanent home available to that person in either State the individual, shall be deemed to be a resident of the State in which the individual has an habitual abode;

- (c) if the individual has an habitual abode in both States or in neither of them, the individual shall be deemed to be a resident of the State of which the individual is a national;
(Editorial Note: Wording as per original *Government Gazette*. It is suggested that the phrase “an habitual abode” is intended to be “a habitual abode”.)
 - (d) if the individual is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.
3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall by mutual agreement endeavour to settle the question and determine the mode of application of the Agreement to such person. In the absence of such agreement such person shall be considered to be outside the scope of the Agreement except for the provisions of Article 25.

Article 5 ***Permanent Establishment***

- 1. For the purposes of this Agreement, the term “permanent establishment” means a fixed place of business through which the business of the enterprise is wholly or partly carried on.
 - 2. The term “permanent establishment” shall include—(a) a place of management; (b) a branch; (c) an office; (d) a factory; (e) a workshop; (f) a warehouse, in relation to a person providing storage facilities for others; (g) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources; and (h) an installation or structure used for the exploration of natural resources.
- ...
- 7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Article 7 ***Business Profits***

- 1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
- 2. Subject to the provisions of paragraph 3 of this Article, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
- 3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment including executive and general administrative expenses so incurred, whether in the Contracting State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent

establishment. Likewise, no account shall be taken, in determining the profits of a permanent establishment, of amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 of this Article shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary. The method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.
5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.
6. For the purposes of the preceding paragraphs of this Article, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.
7. Where profits include items of income which are dealt with separately in other Articles of this Agreement, then the provisions of those Articles shall not be affected by the provisions of this Article.

Article 21 Other Income

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Agreement shall be taxable only in that State.
2. The provisions of paragraph 1 shall not apply to income if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case, the provisions of Article 7 shall apply.
3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of the Agreement and arising in the other Contracting State may also be taxed in that other State.

INITIAL TEST OF COMPETENCE, JANUARY 2019
PROFESSIONAL PAPER 4

QUESTION 2 – REQUIRED		Marks	
		Sub-total	Total
(a)	Calculate the taxable income of ZI for the 2018 year of assessment, starting with the taxable income calculated by the accountant and taking into account the information provided in the accountant's notes (transactions 1 to 5).	36	
	Provide reasons to support calculations for the tax treatment applied. <i>Communication skills– clarity of expression; layout and structure</i>	2	38
(b)	Discuss the VAT implications for ZI with regard to transactions 1.1 to 1.3 and 2 in the scenario.	9	
	<i>Communication skills– appropriate style</i>	1	10
Total for question 2			48