PAPER 1 QUESTION **100 marks**

SA Solar (Pty) Ltd ('SA Solar') was established in 2010 in Durban. SA Solar's income is derived solely from the manufacture of solar panels. SA Solar is 100% held by Mr Phumlani Motswedi, a highly successful South African businessman. Phumlani is married in community of property to Mrs Precious Motswedi. Phumlani and Precious have a daughter named Mwanawa and they are all South African tax residents.

1 Background on SA Solar

SA Solar is a pioneer in the manufacture of solar panels in South Africa. These solar panels are the most efficient method of generating electrical power by using solar cells. Solar cells produce electricity from sunlight to power equipment or rechargeable batteries.

SA Solar's main customers are large wholesale chains as well as a number of small wholesalers in South Africa. SA Solar's main competition is solar panel producers in Europe and China. Despite SA Solar's cost advantage – gained from lower transport and insurance costs – the European and Chinese suppliers are able to compete in the local market because of their lower production cost arising from economies of scale. Furthermore, there is a perception among the South African public that the imported solar panels are of a higher quality.

SA Solar manufactures its solar panels by means of the following processes:

- Solar cells: Each solar panel is made up of 72 solar cells that are wired together. The imported solar cells are extremely fragile and need to be handled with great care while being transported and used in the manufacture of solar panels.

- Laminating and framing: A sheet of glue is placed on the front and back of the wired solar cells. A layer of solar glass is added on top (the part of the solar panel that will face the sun) and a plastic film (PVF) at the back. A laminating machine heats the sheets of glue so that they melt and 'glue' the glass, solar cells and PVF together and seal the solar panel. An aluminium frame that enables the solar panel to be mounted is added around the panel. Finally, a junction box, which connects panels to each other and/or to other electrical circuits, is connected to the solar panel.

  The wiring of the solar cells and the lamination of the solar panels are automated, although machine operators control the machines. The aluminium frames and junction boxes are installed manually.

- Testing and quality control: Once the solar panels have been framed and the junction boxes connected, a qualified electrician performs a series of stringent quality control tests on the solar panels before they are cleared for sale and distribution.

SA Solar is a Category B value-added tax (VAT) vendor. SA Solar has a February year end. The South African Revenue Service (SARS) regards the manufacture of solar panels as a process of manufacture. Since incorporation, SA Solar has planned its tax affairs to minimise its tax liability.

2 Standard costing system (all amounts provided in section 2 exclude VAT)

SA Solar operates a variable standard costing system. The following standards were amongst others set for the year ended 28 February 2018 (FY2018):

2.1 A standard selling price of R1 600 per solar panel was set based on budgeted sales of 11 125 solar panels.

2.2 Each solar panel requires 72 solar cells. However, because the cells are so fragile, a normal loss of three cells per solar panel is budgeted for. Based on an expected exchange rate of the Chinese yuan renminbi (CNY) to South African rand (ZAR) of CNY1 : ZAR2, the standard cost was set at R5 per solar cell.

2.3 Each solar panel requires 2,5m^2 solar glass at a total standard cost of R150 per panel and 2,5m^2 PVF at a total standard cost of R300 per panel.

2.4 The standard cost of other direct materials, incorporating the wiring, junction box, glue sheets and aluminium frame, was R160 per solar panel.

2.5 Budgeted fixed manufacturing overheads were R1 150 000. The standard variable manufacturing overheads per solar panel was R100. Fixed manufacturing overheads include depreciation on machinery and the salaries of the machine operators and electrician.

2.6 No losses were budgeted to occur as a result of the inspection and quality control tests.

SA Solar's management accountant has gathered the following information to assist with the preparation of the annual variance report:

(a) Total revenue for FY2018 was R18 760 000. Sales were boosted above the budgeted 11 125 solar panels when SA Solar won a tender, which was not budgeted for, to supply 500 solar panels for a solar farm installation on the roof of a large shopping mall in Johannesburg. The supply of the panels commenced in November 2017 and was completed during January 2018. To ensure that the tender did not have any impact on existing budgeted sales volumes, the machine operators and electrician were paid a total of R75 000 overtime that had not been budgeted for. SA Solar had sufficient spare machine capacity to meet the supply.

(b) In February 2018, SA Solar switched to a new supplier of PVF whose price was 5% cheaper than that of the supplier they had used previously. A total of 2 350 m^2 of PVF was purchased from the new supplier and used in production in February 2018. However, because the new PVF turned out to be of a poorer quality, 100 solar panels failed the quality assurance tests and had to be scrapped.

(c) A total of 875 550 solar cells were purchased and used, at an average price of R5,62 each.

(d) 11 825 solar panels were produced (which include the 100 solar panels that were scrapped) during FY2018.

(e) There were no price increases for any of the other direct materials.

Apart from those arising from the information gathered by the management accountant, no other variances arose during FY2018. There was no opening stock of raw materials or finished goods on hand at the start of FY2018.

3 SA Solar's future plans

In view of its success with the solar farm installation for the shopping mall, SA Solar plans to expand into the retail segment during FY2019. SA Solar expects that the extra demand created through this expansion will enable it to have the financial ability to invest in its own solar cell manufacturing capabilities rather than having to import solar cells. SA Solar has accordingly invested in new machinery to manufacture its own solar cells.

SA Solar foresees that it will probably have to end a number of existing relationships with smaller wholesalers to enable it to meet the anticipated demand.

SA Solar's management accountant has argued that to ensure that a true cost is obtained, absorption costing should be used to determine the selling price at which the solar panels should be introduced to the retail segment. The management accountant has therefore prepared the following standard cost schedule to assist with determining the selling price:

Standard cost schedule		
	Notes	**R per solar panel**
Solar cells	3.1	375
Solar glass	3.1	150
PVF	3.1	300
Other materials	3.1	160
Variable manufacturing overheads	3.1	100
Fixed manufacturing overheads	3.1, 3.2	102
Less: Government subsidy	3.3	(250)
Total cost per solar panel		937

Notes

3.1 These costs are the same as the FY2018 standard costs.

3.2 The allocation of the fixed manufacturing overheads is based on FY2018 machine hours.

3.3 SA Solar would like to benefit from the government subsidies that are paid to incentivise clean energy schemes such as solar power. To qualify for the subsidies, organisations are required to have a level II or better B-BBEE rating. SA Solar currently does not have the required rating, but Phumlani does have a contact in the Department of Energy. He is confident that, through this contact, the B-BBEE rating requirement will not be imposed.

4 Information relating to the year of assessment ended 28 February 2018

SA Solar earns its income only from its manufacturing activities and earns no investment income. The taxable income amounted to R1 222 759, before taking the following transactions into account:

4.1 On 23 February 2018 trading stock was sold on credit to a customer, The Power Store CC ('The Power Store'). The sale of this trading stock, amounting to R160 000, is not included in the taxable income of R1 222 759 above. The trading stock was delivered on the same date but is still reflected in the closing stock value. In anticipation of this purchase The Power Store applied for a loan from Investor Bank to fund the purchase. The sale agreement provided for normal credit repayment terms, that is, 30 days to pay. The sale agreement contained the following clause:

This agreement is subject to, and conditional upon, the purchaser supplying the seller with a copy of the finance approval by the purchaser's banker within ten (10) days of the date of signature.

Investor Bank approved The Power Store's application for financing this purchase on 1 March 2018. The Power Store provided the necessary finance approval to SA Solar within the stipulated period as per the sale agreement.

4.2 On 16 March 2014, two automatic laminating machines were acquired new and unused from Current Automation (Pty) Ltd ('Current Automation'), an independent local supplier. The machines cost R499 999 (excluding VAT) each, after taking into account a 50% discount. One of the machines (machine 1) was immediately brought into use by SA Solar in the manufacture of solar panels and the other machine (machine 2) was kept on hand.

Eskom introduced load shedding during December 2016, which created a huge demand for solar panels. As a result, machine 2 was also brought into use on 1 March 2017. As machine 2 coped well with the demand, SA Solar sold machine 1 to ARTSolar (Pty) Ltd, an independent local manufacturer, on 17 July 2017 for R749 999 (excluding VAT).

4.3 The full proceeds received from the sale of machine 1 were used to fund the purchase of a new aluminium cutting machine on 1 August 2017 at a cost of R900 000 (excluding VAT), as the machine in use at that time, needed to be replaced in due course. However, as the current machine was still in use by 28 February 2018, the new machine had not yet been brought into use by SA Solar.

4.4 SA Solar acquired a second-hand automatic laminating machine from Current Automation on 9 August 2017 for R250 000 (excluding VAT).

4.5 The following transactions were entered into relating to payment for services:

Payment for services	**R (excluding VAT)**
Insurance premium paid on 1 February 2018 relating to the insurance cover for the period 1 February 2018 to 31 August 2018	79 512
Machinery maintenance contract paid on 20 February 2018 for services to be rendered for the period 1 March 2018 to 28 February 2019	98 319

4.6 A consignment of trading stock consisting of solar cells to the value of CNY100 000 was imported from Asia Solar in China. The order was placed on 9 February 2018, the products were loaded free on board at shipping on 9 February 2018, and arrived in South Africa and were cleared through Customs on 19 March 2018. Import duties calculated and paid on clearance amounted to R23 967. No payments had been made to Asia Solar by the year end.

The exchange rates on the relevant dates were as follows:

Date	**Exchange rate**
9 February 2018	CNY1 = ZAR2,50
28 February 2018	CNY1 = ZAR2,28
19 March 2018	CNY1 = ZAR2,01
Average for the 2018 year of assessment	CNY1 = ZAR2,25

4.7 Marketing and entertainment expenses include the following two payments:

- A payment of R248 663 (excluding VAT). This relates to the Motswedi family's holiday to Dubai during December 2017.
- A cash payment of R100 000 was made directly to the Chairman of the Tender Committee at the uMgungundlovu District Municipality (uMDM). Phumlani is a school friend of the Chairman. SA Solar won a R2 million tender to supply solar panels to the uMDM shortly after the payment was processed.

Phumlani met with SA Solar's tax practitioner and they agreed to claim all deductions processed in respect of marketing and entertainment expenses when submitting the 2018 tax return. The tax practitioner is a registered tax practitioner with SARS and also a member of the Law Society of South Africa.

4.8 The following bonuses, commission for the sales team and overtime payments accrued to some of SA Solar's employees. These amounts were paid in March for both the 2017 and 2018 years of assessment:

	2018	**2017**
	R	**R**
Accruals in respect of bonuses, commission to the sales team and overtime	189 221	155 915

4.9 A cash donation of R250 000 was made to the Hope Factory on 1 June 2017, which is a section 18A approved SARS public benefit organisation.

5 Additional information relating to the 2018 year of assessment of Phumlani and Precious

Phumlani earned a monthly cash salary of R150 000 from SA Solar during the 2018 year of assessment. Phumlani made the following contributions per month:

Monthly contributions	**2018**
	R
Medical scheme fees: 50% of the fees	1 500
SA Solar's provident fund: 7,5% of his salary of R150 000	11 250

In addition, SA Solar made the following monthly contributions towards Phumlani's remuneration:

- 50% towards medical scheme fees; and
- 10% of his salary of R150 000 towards the provident fund.

On 1 March 2017, SA Solar provided a loan to Phumlani amounting to R2 039 508. The loan was granted to Phumlani in his capacity as a shareholder. The loan bears no interest and has no repayment terms. The loan remained constant throughout the year of assessment.

SARS's official rates of interest:

Date from	**Date to**	**Rate**
01.04.2016	31.07.2017	8,00%
01.08.2017	31.03.2018	7,75%

Phumlani owns a residential flat in Sandton that he acquired on 1 March 2008 for R1 500 000. He rented out this flat to his brother from the date of purchase. He made a loss from renting

out this flat during the 2018 year of assessment of R19 888. He also made a loss from renting out this flat during the 2017 years of assessment.

Phumlani made a net capital gain of R100 000 in respect of an asset that is excluded from the joint estate.

Phumlani has no dividend- or interest-bearing investments.

Precious earned interest from a local South African bank amounting to R30 000.

INITIAL TEST OF COMPETENCE, JUNE 2019

PROFESSIONAL PAPER 1

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

PAPER 1 PART I REQUIRED		**Marks**	
		Sub-total	**Total**
(a)	Discuss the normal tax implications for SA Solar in respect of the sale of trading stock to The Power Store for the 2018 year of assessment. Refer to case law principles.	5	5
(b)	Discuss whether SA Solar would qualify as a small business corporation and calculate the taxable income of SA Solar for the 2018 year of assessment, on the assumption that it does qualify as a small business corporation. • Start with taxable income of R1 222 759. • Provide reasons where no tax implications arise in respect of a specific item. *Communication skills – presentation; clarity of expression*	30 *2*	32
(c)	Discuss the ethical concerns you may have regarding the conduct of Phumlani, SA Solar's tax practitioner and SA Solar. Include any actions that SARS may take against any of these parties. *Communication skills – appropriate style*	9 *1*	10
(d)	Calculate the taxable income of Phumlani for the 2018 year of assessment. Provide reasons where no tax implications arise in respect of a specific item.	18	18
Total for part I			**65**

INITIAL TEST OF COMPETENCE, JUNE 2019

PROFESSIONAL PAPER 1

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

PAPER 1 PART II REQUIRED		**Marks**	
		Sub-total	**Total**
(e)	Based on the information provided by SA Solar's management accountant, prepare the FY2018 variance report that shows the calculation of the standard cost variances that occurred during FY2018. Where materials usage (quantity) variances have arisen for the same reason, a combined usage variance may be calculated.	15	
	Communication skills – presentation	*1*	16
(f)	Critically discuss the standard costing schedule in paragraph 3 as a basis for determining the price at which the solar panels should be introduced to the retail market. No calculations are required.	10	
	Communication skills – logical argument	*1*	11
(g)	Discuss the key business risks for SA Solar with regard to the manufacture and sale of solar panels.	8	8
Total for part II			**35**
TOTAL FOR THE QUESTION			**100**