

1 Background

The XoliXaba Trust is a discretionary trust and was established in 1995. Xoliswa Xaba is one of the three trustees of the Trust and the other two trustees are an attorney and a CA(SA), neither of whom is a connected person in relation to Xoliswa. The beneficiaries of the Trust are Xoliswa's three children, all of whom are over 18 years of age.

Constak (Pty) Ltd ('Constak') was incorporated in 1996. The Trust has held all the Constak shares in issue since its incorporation. Constak developed from small beginnings to a large, diversified group that operates throughout South Africa and its neighbouring countries. Xoliswa is the chairperson of the Board of Directors of Constak.

Constak has a December year end and is a Category C VAT vendor. Constak had an assessed loss of ZAR845 000 at the end of the 2018 year of assessment.

Constak has three divisions, namely retail, project management and investments. The retail and project management divisions operate by means of branches – these are not separate legal entities. The retail division sells building products and has several branches in South Africa and one in Morocco. The project management division provides project management services for small construction companies in South Africa. The investment division manages the company's investments in various subsidiaries, including in Sogren Properties (Pty) Ltd ('Sogren'), a company in which it has a 70% holding.

2 Constak retail division

The detailed income statements of the South African and Moroccan branches of the retail division for the 2019 year of assessment are set out below. The results of the Moroccan branch, which is a permanent establishment, are shown in Moroccan dirhan (MAD). The Moroccan general tax administration authority charges corporate income tax at a rate of 25% on the profits of any branch of a non-resident company. Constak paid corporate tax of MAD545 000 to the Moroccan general tax administration authority in December 2019.

South Africa does not have a double tax agreement with Morocco. Assume that the taxable income of the Moroccan branch as determined for South African tax purposes will be equal to the taxable income for Moroccan tax purposes.

CONSTAK (PTY) LTD RETAIL DIVISION INCOME STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2019					
	Notes	South African branches		Moroccan branch	
		ZAR'000	ZAR'000	MAD'000	MAD'000
Sales			466 012		60 902
Cost of sales			(266 600)		(43 809)
Opening inventory		74 640		10 196	
Purchases		283 760		46 563	
Less: Closing inventory		(91 800)		(12 950)	
Gross profit			199 412		17 093
Less: Expenses as detailed below			(168 807)		(14 913)
Compensation to employee	2.1	175		–	
Provision for warranty costs	2.2	5 782		–	
Donations	2.3	100		–	
Operating expenses (all tax deductible)		162 750		14 913	
Profit before taxation			30 605		2 180

Notes

2.1 Compensation to employee

Constak's Moroccan branch is currently managed by Ms Dipuo Motse, a South African resident who was seconded to Morocco in November 2017 for a period of three years. Dipuo's salary is paid through the Moroccan branch's payroll while she is working there.

Dipuo was involved in an accident at work in December 2018: she was run over by a forklift that was being driven by a fellow employee who was stacking boxes in Constak's Rabat warehouse. Dipuo suffered multiple fractures to both her legs and had to undergo a six-hour operation, followed by a long period of rehabilitation. As a result of the accident she was unable to work for three months and incurred substantial medical expenses, which she was unable to recover from her medical aid fund.

Dipuo paid her medical expenses in February 2019 and lodged a claim against Constak for ZAR175 000, being the medical costs that were not recoverable. Constak's head office in South Africa paid the claim to Dipuo on 31 May 2019. Constak's Moroccan branch paid Dipuo her full salary of MAD40 000 per month throughout the period that she was booked off. This is included in the Moroccan branch's operating expenses.

2.2 Provision for warranty costs

Constak provides a six-month warranty on products sold by its South African branches. In terms of the warranty and in accordance with the applicable provisions of the *Consumer Protection Act, 2008* (Act 68 of 2008), goods will be refunded or exchanged if the goods are defective, unfit for its purpose or failed due to a design or manufacturing flaw. Customers claiming under the warranty are required to present their original tax invoice or till slip as proof of purchase. Once Constak accepts a return and approves a refund, the refund is paid to the customer within three days of being approved.

Constak raises a provision for warranty costs equal to the estimated expenditure required to settle its warranty obligation. The provision for warranty costs was as follows for the 2019 financial year (FY2019):

	ZAR
Balance at 1 January 2019	1 927 800
Provisions raised on goods sold during the year	5 782 000
Refunds paid during the year	(5 926 800)
Balance at 31 December 2019	1 783 000

2.3 Donations

Constak made the following donations during the 2019 year of assessment:

2.3.1 A cash donation of ZAR100 000 to the Johannesburg Children's Home. It has been approved by the South African Revenue Service as a public benefit organisation. Constak received a section 18A receipt for the donation.

2.3.2 Building supplies that were donated from inventory to a local pre-school did not qualify for a section 18A receipt. The trading stock cost ZAR240 000 and had a selling price of ZAR475 000 (both amounts exclusive of VAT). The cost of the trading stock was included in the inventory purchases for the year but not included in closing inventory.

3 Sogren

Sogren undertakes construction and property development in South Africa. It has a December year end and is a Category B VAT vendor. Sogren has constructed several blocks of flats and it usually sells the individual flats as soon as they have been completed.

Sogren experienced cash-flow problems and the directors took the following courses of action:

3.1 Forev (Pty) Ltd ('Forev') is an investment management company that is solely owned and managed by Mr Sandile Xaba, the son of Xoliswa. Forev offered an interest-free loan of ZAR2 million to Sogren. The loan was advanced on 1 March 2018 and has a repayment date of 29 February 2020.

3.2 Sogren was unable to sell ten of the flats in one of the blocks it had constructed, and let them in terms of lease agreements, for ZAR10 000 each per month. The ten flats were constructed at a combined cost of ZAR7 million and the open market value was ZAR10 million on 1 March 2019. All lease agreements were entered into on 1 March 2019. The insurance premiums amount to ZAR1 650 (excluding VAT) per flat per month and the annual amount is payable by Sogren in advance on 1 August each year.

4 Additional information – exchange rates

	1 MAD : ZAR
1 January 2019	1,3362
31 May 2019	1,3390
31 December 2019	1,3400
Average exchange rate for FY2019	1,3380

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QUESTION 2 – REQUIRED		Marks	
		Sub-total	Total
(a)	Discuss, with reference to the principles of relevant case law and the <i>Income Tax Act, 1962</i> (Act 58 of 1962), as amended, whether the payment of ZAR175 000 may be claimed as a deduction by Constak in the 2019 year of assessment. <i>Communication skills – logical argument</i>	10 1	 11
(b)	Calculate the normal tax payable by Constak for the 2019 year of assessment based on the information provided in the scenario. Start your calculation with the branch profits disclosed in the income statements. <i>Communication skills – presentation</i>	13 1	 14
(c)	Explain, with supporting calculations, the donations tax implications arising from the loan for Sogren, Forev and/or Sandile. Assume that the official rate of interest for the period was 7,75%.	10	10
(d)	Explain, with supporting calculations, with regard to the letting of the flats – (i) all the VAT implications for Sogren; and (ii) in which year(s) of assessment the insurance payment made on 1 August 2019 may be claimed as a deduction by Sogren for normal tax purposes.	8 4	 12
Total for the question			47