

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

SAMPLE EXAM

MODULE 2.12 – SOUTH AFRICA OPTION

ADVANCED INTERNATIONAL TAXATION (JURISDICTION)

TIME ALLOWED – 3¼ HOURS

This exam paper has **three** parts: **Part A**, **Part B** and **Part C**.

You need to answer **five** questions in total. You will **not** receive marks for any additional answers.

You must answer:

- **Both** questions in **Part A** (25 marks each)
- **One** question from **Part B** (20 marks)
- **Two** questions from **Part C** (15 marks each)

Further instructions

- All workings should be made to the nearest month and in South African rand, unless otherwise stated.
- You must provide appropriate line breaks between each question, and clearly indicate the start of each new question using the formatting tools available.
- Marks may be allocated for clarity of presentation of your answers.
- The time you spend answering questions should correspond broadly to the number of marks available for that question. You should therefore aim to spend approximately half of your time answering Part A, and the other half answering questions in Parts B and C.
- There is no separate reading time, so you can start typing your answers as soon as the exam begins. However, we recommend that you set aside some time to thoroughly read each question and plan each of your answers.

PART A

You are required to answer BOTH questions from this Part.

1. You work as a consultant at one of South African's top tax advisory firms. Bob, a South African tax resident, has sought your tax advice.

Bob has a business that generates income from the sale of ribbons. The ribbons are currently sold in South Africa and four other African countries. Bob believes it is unnecessary to pay taxes on the sales income he generates both in South Africa and through exports. He has spoken to acquaintances, and they have assured him that it is possible to completely avoid South African taxes on the sales income.

Based on advice from his acquaintances, Bob intends to incorporate a 100% owned company (IOM Co) in the Isle of Man. Bob will then restructure his supply chain as follows:

- Bob will continue to manufacture the ribbons in South Africa.
- Bob will sell the ribbons to IOM Co at cost (ensuring that he covers the manufacturing cost plus a small salary for himself).
- IOM Co will distribute the ribbons, with a commercial margin, to Bob's South African and non-South African customers.
- Bob will deliver all goods directly to the South African customers on behalf of IOM Co (i.e. these goods will not leave South Africa).
- IOM Co will be subject to a corporate tax rate of 0% in the Isle of Man.
- Bob has taken additional advice and is assured that IOM Co will not be subject to any taxes in the countries to which the ribbons are distributed.

Bob requires confirmation that his intended supply chain solution would shelter him from South African tax on the revenue generated from the sale of ribbons via IOM Co.

You are required to answer the questions below, with reference only to South Africa's income tax and VAT laws:

- 1) **Explain the South African income tax implications for Bob, regarding the structure he has proposed to sell ribbons. Would locating IOM Co in a country which has a double tax agreement with South Africa change your advice, and on what basis?** (12)
- 2) **Discuss the extent to which, under South African tax law, the establishment of substantive business operations in the Isle of Man would help Bob to mitigate tax in South Africa on the income generated by IOM Co.** (4)
- 3) **Outline the extent to which the South African transfer pricing regime could have an impact on this structure, and provide details of any such impact.** (4)
- 4) **Discuss any South African VAT concerns that may arise from the proposed changes to Bob's business model.** (5)

Where your advice relies on assumptions, you should note the assumptions in your answer.

Total (25)

2. ALFA Corporation (ALFA Corp.) is incorporated in Country N and is a key player in the power generation business under the well-known 'Top Energy' brand. The shareholders of ALFA Corp. are Mr Duns and Mrs Smith, who are residents of Country U and each hold 50% of the shares. ALFA Corporation has no business operations or employees in Country N. It has a shared office in the Netherlands, which it uses three times per year to host meetings of its board of directors. The board decided at a recent meeting that all income derived by ALFA Corp. from its businesses should immediately be paid to the shareholders.

BETA Corporation (BETA Corp.), another energy company incorporated in Country N, owns an immovable property in an industrial area of South Africa. ALFA Corp. has initiated a joint venture agreement with BETA Corp., to engage in energy production in South Africa.

Under the terms of the joint venture, ALFA Corp. and BETA Corp. incorporated a subsidiary in South Africa (ALFA-BETA Ltd), in which ALFA Corp. granted a cash contribution of R20 million, while BETA Corp. contributed its aforementioned immovable property in consideration for shares issued by ALFA-BETA Ltd.

More than 80% of the value of ALFA-BETA Ltd's shares derives from the immovable property it holds. The shares in ALFA-BETA Ltd are accordingly held 20% by ALFA Corp. and 80% by BETA Corp.

ALFA-BETA Ltd became the owner of the immovable property and, with the R20 million contributed by ALFA Corp., ALFA-BETA Ltd begun constructing the power generating station in South Africa.

ALFA Corp., BETA Corp. and ALFA-BETA Ltd entered into a commercial agreement, under which:

- ALFA-BETA Ltd will distribute annually dividends to ALFA Corp. and BETA Corp.
- ALFA Corp. has granted a low-interest loan of R50 million to ALFA-BETA Ltd to complete the construction of the power generating station.
- ALFA-BETA Ltd will pay to ALFA Corp. a yearly fee for the right to use the 'Top Energy' brand in South Africa.

You may assume that South Africa and Country N have signed a double taxation agreement (DTA) that is based on the OECD Model Tax Convention.

You are required to address the following matters, with reference to South Africa's domestic tax laws, court cases and DTA provisions:

- 1) **Discuss the tax implications of the dividends, interest and brand payments made by ALFA-BETA Ltd for all relevant parties.** (12)
- 2) **Prior to the joint venture with ALFA Corp., BETA Corp. obtained rental income from its immovable property in South Africa. What are the tax implications of the rental income that was derived by BETA Corp.?** (4)
- 3) **Discuss the tax implications of the immovable property contribution made by BETA Corp. to ALFA-BETA Ltd.** (4)
- 4) **Subsequently, ALFA Corp. and BETA Corp. sold their shares in ALFA-BETA Ltd to ZICO Corporation, an energy company incorporated in Country S. What are the tax implications of the sale proceeds?** (5)

Total (25)

PART B

You are required to answer ONE question from this Part.

3. Martina was born and raised in South Africa, where she intends to remain. After qualifying as an engineer, Martina started her own business. After working for 20 years, she sold the shares in the company she had built and now has R25 million that she intends to invest in companies listed on the New York Stock Exchange and London Stock Exchange.

Martina has been referred to you, as a leading individual tax adviser, to help her externalise the funds in a legal manner into an offshore brokerage account; the account belongs to her appointed independent broker, who is based in the United Kingdom.

Martina would also like an understanding of how she will be taxed on the gains and dividends she generates from these investments. She has asked that you include illustrative examples, assuming she generates a dividend of \$100 from the United States and a capital gain of £100,000 from the UK in a year of assessment.

You may make the following assumptions:

- Martina will own these assets and trade them in her own name, not through a foreign owned vehicle.
- Martina will hold the assets on a long-term basis, and will only trade them if absolutely necessary (i.e. you may treat them as capital assets).
- Martina will only acquire nominal shareholdings in listed companies (i.e. she will never own even 1% of the total shareholding in a company).
- The average exchange rates for the year of assessment and the spot rates on the date of accrual of the dividend and sale of the asset are R18: \$1 and R22:£1. You may assume that the average rate and spot rate on the relevant date are equal.
- Martina will acquire and sell all US and UK shares in \$ and £ respectively.
- Martina is currently taxed at a marginal rate of 45%.

Martina has been told by her UK broker, whose information you can assume to be correct, that the following tax rates will apply to any income generated from her investments:

<u>Income stream</u>	<u>UK</u>	<u>US</u>
Dividend income	0% (unless it's a real estate investment trust (REIT) investment, in which case 15% will apply)	15%
Capital gains	0%	0%

You are required to:

- 1) **Set out how Martina can externalise the R25 million, with reference to South Africa's exchange control regime.** (10)
- 2) **Set out how Martina will be taxed on the dividends and capital gains arising from the investment of the funds, with reference to South Africa's income tax laws.** (10)

Total (20)

4. Pharmaco Corporation (Pharmaco) is a pharmaceutical company incorporated in Country A, and is listed on the Johannesburg Stock Exchange. It is considering making a large investment in South Africa. Both Country A and South Africa impose tax on the worldwide income of resident companies and apply the source basis of taxation to non-resident companies.

South Africa and Country A both tax capital gains in a similar manner, and have signed a double tax agreement that is based on the OECD Model Tax Convention.

Pharmaco's management has to decide whether to invest in South Africa by incorporating a wholly-owned subsidiary corporation or by establishing a branch in South Africa.

You are required to answer the following:

- 1) **Briefly describe what the tax consequences in South Africa will be if Pharmaco incorporates a wholly-owned subsidiary, in South Africa, which earns business profits.** (3)
- 2) **What will be the tax consequences if Pharmaco establishes a branch in South Africa, which earns business profits?** (3)

In 2017, Pharmaco decided to establish a subsidiary company (SUBCO) to carry on its business in South Africa. SUBCO leases office space in an office building located in Johannesburg to carry on its business activities.

Mr Jones, a resident of Country A, is an employee of Pharmaco Corporation. He was sent by Pharmaco to South Africa for seven months to ensure that SUBCO complies with its obligations under its contract with Pharmaco. Mr Jones used an office in SUBCO's office space for the entire seven months. When Mr Jones returned to Country A, Pharmaco Corporation hired Peter, an independent consultant and also a resident of Country A, to replace Mr Jones. Peter spent 7 months working in South Africa at the SUBCO office.

- 3) **What are the tax consequences of Mr Jones' work for Pharmaco in Country A and in South Africa?** (7)
- 4) **What are the tax consequences of Peter's work for Pharmaco in Country A and in South Africa?** (7)

Total (20)

PART C

You are required to answer TWO questions from this Part.

5. Janet intends to launch a business exporting paperclips to Nigeria and Kenya. The intention is for all paperclips to be manufactured in South Africa and exported to the two countries for distribution to clients. Janet plans to establish a joint venture arrangement with a suitable distributor in each country. The distributor will be a local party, with good knowledge of the local market and no previous ties to South Africa.

The joint venture arrangement will take the form of a local subsidiary (i.e. a subsidiary incorporated in both Nigeria and Kenya). Janet will be issued the equivalent of South African ordinary shares in each of the local subsidiaries. The shares issued to Janet will afford her a 45% voting and profit participation interest in each of the subsidiaries, in each of these countries. No other share class will be issued. The local joint venture partner will own the balance of the ordinary share equivalents, and will have control of the local subsidiaries. For each of the subsidiaries, these local joint venture partners will be tasked with daily operational oversight and management of the distribution functions conducted by the subsidiary in its territory.

Janet will sign a distribution licence with each of these companies, granting them the exclusive right to sell the paperclips in these territories. The entities will sell the paperclips to local customers operating in their respective territories.

The cost to Janet of a box of paperclips is R10. She currently sells these to her third-party customers in the South Africa market for R20 each.

Janet plans to sell the paperclips to the Kenyan and Nigerian companies for R10 per box, and expects them to sell them in their local markets for the local currency equivalent of R20.

Janet is happy with this pricing arrangement, as she recognises the value of having a local joint venture partner on the ground in each territory and is comfortable in receiving her profits from the joint ventures by way of dividends generated from her 45% shareholding.

Janet has approached you, as a recognised international tax expert, for confirmation that this intended approach will not trigger any unintended tax consequences for her under South African tax law.

You are required to advise Janet on the following matters, with reference to South Africa's income tax laws:

- 1) **Discuss the extent to which the controlled foreign company tax regime will apply to Janet's proposed structure for the sale of paperclips.** (5)
 - 2) **Discuss how the transfer pricing regime may apply to the proposed structure.** (10)
- Total (15)

6. **You are required to explain the South African tax treatment of an amount vested by the trustees of a foreign trust, in favour of a South African income tax resident individual.**

Your answer should address:

- 1) **a situation in which the trustees vest the income and gains in the same year of assessment that they accrue to the trust;** (5)
- 2) **a situation in which the trustees vest the income and gains in a subsequent year of assessment; and** (5)
- 3) **how ownership by the trust of the share portfolio through a wholly-owned foreign incorporated and tax resident company would affect your analysis.** (5)

Your analysis should be limited to scenarios in which the trust generates dividends from, and capital gains on the sale of, shares held in a portfolio of foreign tax resident companies, where the foreign trust owns more than 10% but less than 50% of the shares in the foreign companies.

Total (15)

7. On 17 July 2015, South Africa and Mauritius re-negotiated their double tax agreement (DTA). Article 4(3) of the renegotiated DTA states that:

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.

Both South Africa and Mauritius have ratified the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (The 'Multilateral Instrument' or 'MLI'). In its covered DTAs, South Africa opted into Article 4 of the MLI which deals with 'dual resident entities', while Mauritius opted out of this Article.

- 1) You are required to discuss how matters relating to dual resident entities will be addressed between South Africa and Mauritius. (5)**

Ms Jacobs is a tax resident of South Africa. She has no assets in South Africa, but holds various assets in Mauritius with a total net value of approximately R20 million. Ms Jacobs has enlisted an estate agent to sell her immovable property in Mauritius.

The South African Revenue Service (SARS) has issued an assessment for R18 million to Ms Jacobs for a South African tax debt. Ms Jacobs has not disputed the assessment, but has not yet paid it. South Africa has signed a DTA with Mauritius that is based on the OECD Model Tax Convention.

- 2) With reference to applicable court cases, discuss the operation of the relevant DTA provisions upon which SARS could rely, to ensure that Ms Jacobs pays her South African tax debt. (5)**

Article 23 of the DTA between South Africa and Uganda, published in May 2001, provides that for purposes of eliminating double taxation as provided for in Article 23(1):

- (2) *...the terms "South African tax paid" and Ugandan tax paid" shall be deemed to include the amount of tax which would have been paid in South Africa or Uganda, as the case may be, but for an exemption or reduction granted in accordance with laws designed to promote economic development in that Contracting State.*
- (3) *A grant given by a Contracting State or a political subdivision thereof to a resident of the other Contracting State in accordance with laws designed to promote economic development in that first mentioned State, shall not be taxable in the other State".*

- 3) You are required to identify the DTA term that is used to describe the above provisions. You should explain why countries include such provisions in their DTAs, and how such provisions operate to eliminate double taxation. (5)**

Total (15)

8. Mr Smith was born in Country U, where he spends some time each year. Under the domestic laws of Country U, all individuals born in that jurisdiction are considered tax resident there. Mr Smith regularly goes on holiday in Country M, and often visits South Africa.

Mr Smith has provided you with the following facts:

- He is a member of Country U's parliament.
- He spends 185 days in South Africa, 140 days in Country U and 40 days in Country M each year, and has done so for the past ten years.
- He owns a flat in Country U, a large seaside villa in Country M (with a yacht moored there) and a house in South Africa.
- He has a wife who permanently lives in South Africa.
- He is a director of Consult Ltd, a company incorporated in Country U, and earns a director's fee from this company for work done in Country U.
- He is a shareholder in a South African coal company, from which he receives dividends.
- He is a member of the South African Golf Club, an association of golfers.
- All of his children are adults who live in Country U.
- All of his pets, his favourite oil paintings, his ancestral home and his car collection are in Country U.
- He does not hold a South African passport.
- The main source of his income, other than that stated above, is interest and dividends from investments in the Cayman Islands.

South Africa and Country U have entered into a double tax agreement (DTA), based on the OECD Model Tax Convention. Both South Africa and Country U tax their residents on a worldwide basis and their non-residents on a source basis.

You are required to discuss Mr Smith's tax residence status, with reference to South Africa's domestic tax laws, court cases and DTA provisions.

(15)