PART A

Ground Sample Ltd is a company that specialises in the testing and analysis of ground samples relating to the construction of roads. In terms of Practice Note 42, this process has been deemed by the Commissioner to be a process similar to a process of manufacture.

Ground Sample Ltd has two investments:

1 Driller Ltd is a wholly owned subsidiary. The holding was acquired on 1 October 2000 for R2 million. The determined market value of the shares on 1 October 2001 of R2,7 million has been adopted as the valuation date value. (The time apportionment alternative should accordingly not be used.) The company was acquired to ensure continued use of a specialised machine used in the work of Ground Sample Ltd. This machine and some cash are the only assets held by this subsidiary.

2 11% of the shares in Foreign Ground Ltd. This holding is seen as strategic, as it will assist Ground Sample Ltd in breaking into foreign markets from 2004. Foreign Ground Ltd is registered in Switzerland (not a designated country). Another company (a SA resident) holds 40% of the shares in Foreign Ground Ltd. The financial year-end of Foreign Ground Ltd is 31 August.

Additional information pertaining to the three companies:
- Driller Ltd and Ground Sample Ltd are both VAT vendors.
- Ground Sample Ltd and Driller Ltd have 28 February financial year-ends.
- The machine held by Driller Ltd is leased to Ground Sample Ltd for R133 000 per month (inclusive of VAT) with the lease charges payable monthly, and is not available for leasing to any other person. This is not an “instalment credit agreement” for purposes of the VAT Act.

The following events pertain to the year of assessment ended 28 February 2003:

1 On 31 July 2002 Ground Sample Ltd purchased a second-hand machine for testing ground samples at a cost of R5 700 000 (inclusive of VAT). Ground Sample Ltd had the machine valued and the market value was set at R5 600 000. Ground Sample Ltd was, however, prepared to pay R5 700 000 as it wanted to establish a strategic alliance with the seller (not a connected person). A loan was raised from a financial institution for the full purchase amount, on the following conditions:
   1.1 The loan bears simple interest of 6% per annum, payable monthly.
   1.2 On conclusion of the loan period of five years an amount of R10 million must be paid to the financial institution.
   1.3 The yield to maturity is 15,96%.

2 On 31 August 2002 Ground Sample Ltd acquired a patented process from Foreign Ground Ltd for R3 420 000. Foreign Ground Ltd is not carrying on an enterprise in South Africa for VAT purposes. On 31 August 2002 Ground Sample Ltd also renewed its own patents at a cost of R570 000 (inclusive of VAT).

3 Ground Sample Ltd is the exclusive stockist of certain items of machinery necessary for testing ground samples. It manufactures and sells these machines to companies engaged in similar ground sample testing activities.
   3.1 Closing stock of machines for tax purposes for the year of assessment ended 28 February 2002 amounted to R7 500 000.
   3.2 According to the accounting records, the closing stock of machines has an original cost of R9 million (exclusive of VAT). However, approximately 6,3% of the original cost of closing stock of machines is written down annually. The Commissioner will accept this write-down at 28 February 2003.
   3.3 The cost exclusive of VAT of the machines manufactured during the year amounted to R15 million.
4 Purchases of spare parts for the various specialised ground sample machines amounted to R2 280 000 (inclusive of VAT) for the year. Half of these were on hand at the end of the year. Spare parts on hand at 1 March 2002 had an original cost of R912 000 (inclusive of VAT).

5 On 31 August 2002 Ground Sample Ltd removed an item of trading stock which was included in the value of manufactured goods per item 3.3. manufactured in the current year, to use for their ground sample work. The item had an original cost of R3 600 000 (exclusive of VAT) but the market value had reduced to R3 300 000 at the date it was removed from trading stock.

6 Sales of machines amounted to R22 800 000 (inclusive of VAT) for the year. Half had been to VAT vendors and half was to non-VAT vendors.

7 Income from contract work regarding testing of ground samples amounted to R57 million (inclusive of VAT).

8 The doubtful debts provision account was reduced by R500 000 from its opening balance of R8 million. The bad debts expense in the income statement (including actual bad debts and the adjustment to the provision for doubtful debts) amounted to R6 million. The Commissioner grants an allowance of 25% of the doubtful debts balance in each year of assessment. (All these amounts exclude VAT.)

9 Interest income from interest-bearing investments amounted to R2 500 000.

10 Salaries and wages paid amounted to R17 100 000. This includes the employees referred to in item 11.7. Other operating costs amounted to R4 900 000 (exclusive of VAT).

11 Driller Ltd was liquidated on 31 August 2002 as part of the restructuring of the group. On 28 February 2002 the balance sheet of Driller Ltd was as follows:

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>R'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machine (carrying value)</td>
<td>2 360</td>
</tr>
<tr>
<td>Cash</td>
<td>750</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3 110</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EQUITY</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td>1 000</td>
</tr>
<tr>
<td>Share premium</td>
<td>250</td>
</tr>
<tr>
<td>Capital profits</td>
<td>100</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1 628</td>
</tr>
<tr>
<td>Deferred taxation</td>
<td>132</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3 110</strong></td>
</tr>
</tbody>
</table>

11.1 Driller Ltd had a capitalisation issue in 1994 of 4:1, which was paid for by capitalising 10% from share premium, 30% from capital profits and 60% from revenue profits.

11.2 In 1995 the company repaid R250 000 out of the share premium.

11.3 An amount of R300 000 from pre-1993 reserves has been included in the retained earnings of Driller Ltd.

11.4 All the deferred taxation relates to revenue items.

11.5 The machine was purchased for R3 200 000 on 1 June 2000. The machine was depreciated for book purposes at 15% per annum, straight line. On 28 February 2002 the tax value of the machine amounted to R1 920 000. No valuation was done on 1 October 2001. The machine was leased up to date of liquidation. (See additional information in par. 3 above.)

11.6 The machine was distributed as a dividend in specie on 31 August 2002, as well as the balance of the assets as a full and final liquidation dividend. At that date the market value of the machine was R3 400 000.

11.7 Ground Sample Ltd incurred R100 000 (exclusive of VAT) specialised costs in moving the machine while salaries relating to time spent by regular employees of Ground Sample Ltd on installing the machine amounted to R22 800. The machine was brought
into use on 1 October 2002 by Ground Sample Ltd. The Commissioner allows a write-off of six years on all qualifying assets.

11.8 Liquidation costs amounted to R57 000 (inclusive of VAT).

12 A dividend was received from Foreign Ground Ltd on 31 August 2002. The following is an extract from the income statement of Foreign Ground Ltd for the year ended 31 August 2002:

<table>
<thead>
<tr>
<th></th>
<th>€'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before taxation</td>
<td>20 000</td>
</tr>
<tr>
<td>Taxation</td>
<td>(5 000)</td>
</tr>
<tr>
<td>Profit available for distribution</td>
<td>15 000</td>
</tr>
<tr>
<td>Dividend paid</td>
<td>(5 000)</td>
</tr>
<tr>
<td>Profit transferred to retained earnings</td>
<td>10 000</td>
</tr>
</tbody>
</table>

It is accepted that the net income of Foreign Ground Ltd is attributable to the business it is conducting through a business “enterprise”.

The dividend paid to Ground Sample Ltd was subject to a 10% withholding tax. Ground Sample Ltd does not elect to be taxed on net dividends. On 31 August 2002 the exchange rate was 1€ = R17. Profits are wholly from foreign income. The profit before taxation is equivalent to the taxable income of Foreign Ground Ltd.

REQUIRED

Calculate the taxes payable, in terms of the Income Tax Act, by Ground Sample Ltd for the 2003 year of assessment based on the available information. Show all your workings, including your capital gains tax calculations.

(47)

PART B

Ground Sample Ltd has acted as sole agent for Beart Ltd, registered in the United Kingdom, since November 1990. Beart Ltd has now granted another party the right to also act as agent.

Ground Sample Ltd has initiated action to sue Beart Ltd for compensation. Ground Sample Ltd has been advised by Senior Counsel that, on the facts, any compensation received will be of a capital nature for income tax purposes, in that such a payment “will fill a hole in its income earning structure”.

It is expected that the matter will be settled by June 2003.

REQUIRED

Discuss, giving your reasons, the value-added tax (VAT) and capital gains tax implications in the hands of Ground Sample Ltd if it wins its case and receives an amount of R5 700 000 in compensation.

(8)