Kiddies Cards (Pty) Ltd (“Kiddies”) is a company resident in South Africa. It designs and manufactures cards that are collected by children and sells these cards to producers of breakfast cereals and snack foods. Its financial year ends on the last day of February each year.

The issued ordinary share capital of Kiddies was held as follows throughout the February 2005 financial year:

- 40% by Yugi Yuglyo, a resident of Armenia, a country with which South Africa does not have a double tax agreement;
- 30% by Jessy Ash, a resident of South Africa;
- 20% by Tyson James, a resident of South Africa; and
- 10% by Max Pokemon, a resident of South Africa.

These four shareholders were also the sole directors of Kiddies during the February 2005 financial year. Jessy Ash is its managing director. Jessy Ash, Tyson James and Max Pokemon are all full-time employees and executive directors of Kiddies and as such they receive salaries from the company. Yugi Yuglyo is a non-executive director. All four directors also earn fees for attending directors’ meetings. The meetings are held in South Africa. Directors’ salaries and fees are included in the amount stated under the heading “Salaries, wages and benefits” in the detailed income statement.

Yugi Yuglyo lent Kiddies the equivalent of R650 000 on 30 June 2003. The funds were made available to Kiddies in Armenia. Kiddies transferred the funds to South Africa in July 2003 for use in its business. This loan is denominated in South African rand and has no fixed terms of repayment. It bore interest at a rate of 18% throughout the February 2005 financial year of Kiddies, but no portion was repaid during this period.

(It should be noted that all amounts reflected in the detailed income statement below and in the notes that follow on it, exclude value-added tax (VAT) where appropriate unless specifically stated to the contrary. Kiddies is registered as a vendor for VAT purposes.)

The detailed draft income statement of Kiddies for the financial year ended 28 February 2005 is set out on the next page:
### Gross profit

- **Notes** | **R**
- Sales | 6 250 000
- Less: Cost of sales | (2 500 000)
- Opening stock | (525 000)
- Purchases | (2 575 000)
- Less: Closing stock | (3 100 000)
- **Gross profit** | 3 750 000

### Add: Sundry income

- Dividend income | 29 000
- Capital profit on sale of local shares | 80 000
- Insurance settlement received | 27 360
- Prescribed debt | 6 000
- Profit on sale of machine A | 27 360
- **Add: Sundry income** | 209 860

### Less: Expenditure

<table>
<thead>
<tr>
<th>Notes</th>
<th><strong>R</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bad debts</td>
<td>(45 000)</td>
</tr>
<tr>
<td>Increase in provision for doubtful debts</td>
<td>(6 000)</td>
</tr>
<tr>
<td>Depreciation on motor vehicle</td>
<td>(37 050)</td>
</tr>
<tr>
<td>Depreciation on computer</td>
<td>(5 700)</td>
</tr>
<tr>
<td>Finance charges</td>
<td>(2 200)</td>
</tr>
<tr>
<td>Depreciation on machine A</td>
<td>(12 500)</td>
</tr>
<tr>
<td>Depreciation on machine B</td>
<td>(18 750)</td>
</tr>
<tr>
<td>Depreciation on other machinery and depreciable assets</td>
<td>(86 250)</td>
</tr>
<tr>
<td>Rentals</td>
<td>(67 500)</td>
</tr>
<tr>
<td>Insurance premiums</td>
<td>(81 000)</td>
</tr>
<tr>
<td>Salaries, wages and benefits</td>
<td>(2 900 000)</td>
</tr>
<tr>
<td>Restraint of trade</td>
<td>(336 000)</td>
</tr>
<tr>
<td>Provision for leave pay</td>
<td>(9 500)</td>
</tr>
<tr>
<td>Interest</td>
<td>(117 000)</td>
</tr>
<tr>
<td>Cost of trade mark written off</td>
<td>(40 000)</td>
</tr>
<tr>
<td>Other tax-deductible administrative and marketing expenses</td>
<td>(45 410)</td>
</tr>
</tbody>
</table>

### Net profit before tax

The **Net profit before tax** is **150 000**.

### Additional notes

1. On 1 February 2005, Kiddies concluded a contract to import raw materials from an American supplier at a cost of $24 000. The raw materials were shipped free on board on 22 February 2005 but had not arrived in South Africa by 28 February 2005. Being concerned with the fluctuation of the exchange rate, Kiddies took out a two-month forward exchange contract on 1 February 2005 to cover the settlement of the creditor. The creditor is to be settled on 31 March 2005. Kiddies did not, in its February 2005 financial year, process any accounting entries relating to these transactions. Ruling rates of exchange were as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot rate</th>
<th>Forward rate</th>
<th>Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 February 2005</td>
<td>$1 = R6,55</td>
<td>$1 = R6,70</td>
<td>Two months</td>
</tr>
<tr>
<td>28 February 2005</td>
<td>$1 = R6,60</td>
<td>$1 = R6,75</td>
<td>One month</td>
</tr>
<tr>
<td>31 March 2005</td>
<td>$1 = R6,65</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The average exchange rate for the year ended 28 February 2005 was $1 = R6,50.

2. The following dividends accrued to Kiddies during its February 2005 year of assessment:
- Dividends from companies who are tax resident and operating in South Africa that accrued to Kiddies during the period March 2004 to December 2004. The shareholding of Kiddies in these companies is in all cases less than 50%.

\[ R \]

\[ 20 200 \]

- A distribution from a collective investment scheme in property (a so-called property unit trust). This distribution comprises section 11(s) dividends of R7 800 and interest of R1 000.

\[ R \]

\[ 8 800 \]

\[ 29 000 \]

Total
During its February 2005 year of assessment Kiddies disposed of only the following capital assets:

- Disposal of some of its share investments at a capital profit of R55,000 (as determined in accordance with the Eighth Schedule to the Income Tax Act). The related accounting profit is R80,000.
- Sale (trade-in) on 31 August 2004 of machine A (see note 11).

A road freight contractor had collected an order of cards (trading stock) from Kiddies' premises for delivery to a customer. On its way to its destination the road freight contractor's delivery van, along with Kiddies' trading stock, was stolen. On 15 February 2005 Kiddies was awarded an insurance settlement from its insurer of R27,360 for the stolen trading stock. This amount does not take any possible VAT adjustment that may have to be made into account.

In its February 2002 year of assessment Kiddies had purchased raw materials for R15,000, excluding VAT, from a manufacturer that was closing down. Kiddies paid R9,000 (being 60% of the purchase consideration) on the date of delivery. For the following three years it tried unsuccessfully to pay the 40% balance of the purchase consideration (R6,000). Every cheque posted was returned with “address no longer valid” endorsed on it. Because the debt has now prescribed, the amount owing has been written back in its detailed draft income statement.

Bad debts written off of R45,000 consist of R18,000 for trade debtors and a loan of R27,000 to a supplier who has been liquidated. This loan came about during the previous financial year of Kiddies, when it lent R27,000 to a raw material supplier who was experiencing liquidity problems. The supplier was liquidated on 1 December 2004 and Kiddies has been unable to recover any portion of the loan.

The accounting provision for doubtful debts as at 28 February 2005 was R50,000, an increase of R6,000 from the balance as at 29 February 2004. The Commissioner for the South African Revenue Service (SARS) has over the years consistently allowed a doubtful debt allowance in terms of section 11(j) of the Income Tax Act equal to 25% of the year-end accounting provision.

On 1 June 2004 a motor car used by Kiddies sales staff for visits to customers, was purchased and immediately brought into use. (This motor car meets the definition provided in the VAT Act.) It cost R296,400 (R260,000 plus VAT of R36,400). Depreciation of R37,050 has been provided for on this motor car. SARS Practice Note 19 provides for a five-year write-off period for motor vehicles.

On 1 December 2002 Kiddies leased a computer from a financial institution under a two-year finance lease. Kiddies capitalised the financial lease for accounting purposes and it is an “instalment credit agreement” for VAT purposes. The computer cost the financial institution R19,494 (R17,100 plus VAT of R2,394). Total finance charges in terms of the lease amounted to R4,506 and the monthly rental to R1,000. The final lease rental of R1,000 was paid on 30 November 2004. On 1 December 2004 the financial institution simply abandoned this computer to Kiddies without requiring any further consideration by Kiddies. On this date its fair market value was R11,400 (R10,000 plus VAT of R1,400). Despite being two years old, the computer was still in good working order and Kiddies indeed used it during its entire February 2005 year of assessment. Depreciation of R5,700 has been provided for on the computer. SARS Practice Note 19 provides for a three-year write-off period for computers.

The finance charges of R2,200 expensed to the February 2005 income statement concern the finance lease for the computer in note 9.

On 1 March 2003 Kiddies purchased a new machine (Machine A) on a cash basis in an arm’s length transaction for R100,000. Machine A was immediately brought into use in its process of manufacture. On 31 August 2004 it traded in this machine for a more advanced machine (Machine B). Machine B was purchased as a new machine on a cash basis in an arm’s length transaction for R150,000. A trade-in price of R130,000 was obtained for machine A. On that date machine A had a book value of R62,500. Machine B was immediately brought into use in its process of manufacture. Kiddies will elect any option that is available to it to defer any of its tax liability.
All other machinery and depreciable assets had a nil tax value on 1 March 2004.

The rentals are paid monthly for the use of a warehouse leased by Kiddies for trade purposes.

Insurance premiums of R81 000 were incurred during the February 2005 year of assessment. In addition, Kiddies paid insurance premiums of R78 750 covering the period 1 March 2005 to 28 February 2006 on 15 February 2005, on the advice of its insurance broker who claimed that this early payment would secure cheaper insurance. No portion of the advance insurance premium amount was expensed to its income statement for the February 2005 financial year.

Salaries, wages and benefits of R2 900 000 include directors’ salaries and fees. On 1 September 2004 Kiddies employed an apprentice (a “learner”) on a full-time basis at a wage of R750 per week. (This learner has not previously been employed by Kiddies.) Kiddies entered into a registered learnership agreement with the learner in the course of its trade. The learnership agreement is registered with the relevant Sector Education and Training Authority (SETA). Kiddies has complied with all the requirements of the Skills Development Levies Act. The wages paid to the learner and the levies paid to the relevant SETA are included in the salaries, wages and benefits.

The restraint of trade payment of R336 000 was paid to a designer who had been employed by Kiddies. She left its employ on 30 September 2004. The restraint of trade agreement is effective for two years commencing on 1 October 2004.

The leave pay provision was increased by R9 500 for the February 2005 financial year. As at 28 February 2005 the balance on the leave pay provision amounted to R54 500. Actual leave payments made during the year have been expensed directly to salaries, wages and benefits.

Interest incurred during the February 2005 year on the loan from Yugi Yuglyo amounted to R117 000. The Commissioner for SARS has advised that he is applying the provisions of section 31 of the Income Tax Act to Kiddies. These provisions will be applied effective from 28 February 2005. The prime overdraft rate in South Africa throughout the 12 months ended 28 February 2005 was 14,5% and throughout the February 2005 year the issued share capital of Kiddies was R300 000. It has no reserves other than its retained income. The Commissioner has agreed that a retained income of R175 000 be used when determining any section 31 adjustment for the February 2005 year.

On 1 December 2004 Kiddies purchased outright the “Beyblade” trade mark from another card manufacturer for R40 000. The acquisition gives Kiddies the exclusive right to market cards under the Beyblade trade mark in South Africa.

In January 2004 Kiddies bought stock for R23 940 (R21 000 plus VAT of R2 940) from a local supplier. Kiddies claimed an input tax credit of R2 940 for its tax period 1 December 2003 to 31 January 2004. However, because of quality problems, Kiddies paid the supplier only R19 152 (R16 800 plus VAT of R2 352) on 31 January 2004, refusing to settle the account until the quality problems had been resolved. On 28 February 2005 an amount of R4 788 (R4 200 plus VAT of R588) was still outstanding despite numerous letters of demand from the supplier. The amount was reflected under creditors in the balance sheet of Kiddies as at 28 February 2005. No VAT adjustment that may be required has been reflected in the detailed draft income statement of Kiddies for the February 2005 year. None of this stock was on hand as at 28 February 2005.

Other information


- Yugi Yuglyo visited South Africa on four occasions and for an aggregate of 36 days during the February 2005 year of assessment. During the visits he attended directors’ meetings of Kiddies and visited friends and relatives who live in South Africa. Apart from his interest in Kiddies, he has no other business interests in South Africa. All his gross income from South Africa is
derived from Kiddies. Directors’ fees of R30 000 accrued to him from Kiddies during the February 2005 financial year.

- Kiddies has neither an assessed loss nor an assessed capital loss to carry forward from its February 2004 year of assessment.

**REQUIRED**

(a) Calculate the normal tax liability of Kiddies Cards (Pty) Ltd for its February 2005 year of assessment. Show all workings.  

(b) Calculate any STC liability of Kiddies Cards (Pty) Ltd that arises from the above transactions during the February 2005 year of assessment.  

(c) Calculate Yugi Yuglyo’s South African taxable income for the year of assessment ended 28 February 2005.