### Paper 2 Question 2 Solution

<table>
<thead>
<tr>
<th>NOTE NR.</th>
<th>AMOUNT</th>
<th>MARKS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net profit before tax</strong></td>
<td>150 000</td>
<td><strong>NR.</strong></td>
</tr>
<tr>
<td>Note: Candidates could have started their calculations with sales. An alternative mark plan was used in that case that has the same available number of marks as this solution</td>
<td>0</td>
<td>2</td>
</tr>
</tbody>
</table>

1. **Imported stock in transit.** Section 23F applies, the expense was incurred, but the stock was not disposed of nor held at year end, therefore, no deduction is allowed

2. **Alternative for section 23F above:**
   - Section 11(a) deduction for imported stock ($24 000 x R6,50). The translation to Rands is based on the average exchange rate in terms of section 25D
   - Closing stock, imported stock in transit ($24 000 x R6,50). The translation is based on the average exchange rate in terms of section 25D

   Note: This alternative for the application of section 23F also has a maximum of 2 marks that is available.

3. **Unrealised foreign exchange loss on the amount owing to the foreign creditor is not included in taxable income in terms of section 24I(11), as the debt was incurred by the taxpayer in foreign currency to acquire an asset.**

   Note: The mark plans allowed for the inclusion of an unrealized foreign exchange loss on the amount owing to the foreign creditor of R1 200 ($24 000 x (R6,60-R6,55)). Although this deduction no longer has justification in law, the mark team felt that the degree of difficulty of section 24I(11), its incorrect application in general text books and lack of sufficient guidance in the explanatory memorandums relating to section 24I(11) was a contributing factor to the incorrect application of section 24I(11). Consequently candidates were given a mark for this approach.

4. **Unrealised foreign exchange gain on the forward exchange contract (FEC) not included in terms of section 24I(11)(b). Refer to the previous mark awarded**

5. **Deduct accounting capital profit on sale of local shares**

6. **Bad debts, trade debtors, deductible in terms of section 11(i), no adjustment required**
   - Bad debt, loan to supplier, never included in taxable income, not a moneylender, not deductible, add back (R45 000 – R18 000)

7. **Add back the increase in the accounting provision for doubtful debts, not deductible**
   - Section 11(j), deduction, 2005 provision for bad debts, 25% x R50 000
   - Section 11(j), 2004 provision for bad debts, add back previous year allowance, 25% x R44 000

8. **Add back the depreciation on the motor vehicle**
   - Lease rentals on computer:
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost excluding VAT</td>
<td>R17 100</td>
<td></td>
</tr>
<tr>
<td>Finance charges</td>
<td>R 4 506</td>
<td></td>
</tr>
<tr>
<td></td>
<td>R21 606</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>R21 606</strong></td>
<td><strong>24 months</strong></td>
</tr>
<tr>
<td></td>
<td><strong>R900.25 p.m for 9 months</strong></td>
<td><strong>-8 102</strong></td>
</tr>
</tbody>
</table>

**Alternative for lease rentals on computer:**

The instruction to the question clearly states that all amounts exclude VAT. The monthly rental payment given is R1 000. The original suggested solution treated this as an amount inclusive of VAT. This is not consistent with the instruction that all amounts exclude VAT. Therefore, the mark plans catered for the alternative of rentals as follows: R1 000 x 9 months= R9 000 for 1 mark

**Section 8(5)(bA) recoupment on abandoned computer:**

Original cost to lessor R17 100
Less 20% diminishing balance R 3 402
Less 20% diminishing balance R 2 736
R10 944

Limited to market value exclusive of VAT of R10 000

Limited to rentals paid of R21 606 (alternative, R24 000)

But the amount recouped is always determined at the satisfaction of the Commissioner

Section 11(e), wear and tear on the computer, R10 000 / 1 year x 3/12 months

**Alternative for the calculation of wear and tear on the computer:**

R10 000 / 3 years x 3/12 months = R833

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<tr>
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<tbody>
<tr>
<td>10 Add back accounting finance charges on the lease of the computer equipment</td>
<td>2 200</td>
<td><strong>1</strong></td>
</tr>
<tr>
<td>11 Deduct accounting profit on the sale of machine A</td>
<td>-67 500</td>
<td><strong>1</strong></td>
</tr>
<tr>
<td>12 Add back depreciation on other machinery and depreciable assets</td>
<td>86 250</td>
<td><strong>1</strong></td>
</tr>
<tr>
<td>13 Rentals, deductible under section 11(a)</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>14 Insurance premiums for the 2005 year of assessment, deductible under section 11(a)</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>15 Salaries, wages, benefits, directors fees, deductible under section 11(a)</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>16 Add back the restraint of trade payment, capital in nature</td>
<td>336 000</td>
<td><strong>1</strong></td>
</tr>
<tr>
<td>17 Add back increase in leave pay provision, not deductible</td>
<td>9 500</td>
<td><strong>1</strong></td>
</tr>
<tr>
<td>18 Interest deductible under section 11(a)</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

**Thin capitalization, disallowed interest::**

Share capital + retained income
R300 000 + R175 000 = R475 000 x 40% = R190 000 x 3 times = R570 000
Financial assistance, loan | R650 000  
Excess debt | R80 000  
Therefore, section 31(3) disallowed interest, R117 000 x R80 000/R650 000 | 14 400  

Transfer pricing excessive interest:  
Acceptable debt | R570 000 (as calculated)  
Excessive interest rate, 18% - (14.5% + 2%) = 1.5% |  
Excessive interest, 1.5% x R570 000 | 8 550  

19 Add back the deduction of the trade mark, capital in nature | 40 000  
No section 11(gC) allowance available for trade marks | 0  

20 Cost of VAT adjustment for purchases not paid for within 12 months | -588  

3 Taxable capital gain:  
Capital gains on disposal of local shares | R55 000  
Capital gain on disposal of machine A | R12 000  
Proceeds | R70 000  
Selling price | R130 000  
Less recoupment | R 60 000  
Base cost | R40 000  
Cost price | R100 000  
Less allowances | R 60 000  
R30 000  
Taxed as allowances granted on the new machine, current year, 40%  
= R60k/R150k |  
Capital loss on loan to supplier | -R27 000  
Net capital gain | R40 000  
Inclusion rate of | 50%  

Note: Candidates were not awarded marks if the capital gains tax calculation, specifically the determination of the net capital gain, was not done in the correct place and all of the capital gains or losses were not aggregated as above, as they ignored the fundamentals of CGT. No marks were awarded if candidates simply multiplied each gain or loss with 50% again as they disregarded the fundamental principles of CGT. The only mark that would potentially be awarded is the 50% inclusion rate. The lack of aggregation of capital gains and losses was a major point of concern on which report-back was given after the writing of Part 1 of the 2004 QE  

Other tax-deductible administrative and marketing expenses, already taken into account | 0  
TAXABLE INCOME | 362 690  
Taxed at | 30%  
108 807  
Total marks available | 55  
Maximum marks awarded | 52  

b STC Liability  
Dividend cycle 1  
Cycle ending 15/01/2005  
Amount declared | 10 000  
Less: credits, local dividends received | -20 200  
Less: property unit trust dividends received, no STC credits available | 0  
STC credit carried forward | -10 200  

Dividend cycle 2  
Deemed dividend, section 31 application, cycle ending 28/02/2005  
Deemed dividend | 22 950  
STC credit brought forward | -10 200  
Net dividend | 12 750  
X 12.5% rate of STC | 1 594  
Total marks available | 6  
Maximum marks awarded | 5  

Note: Two distinct dividend cycles arise. Candidates who only calculated STC for one dividend cycle had this dividend cycle marked as dividend cycle number 1 as they made a fundamental error in determining when STC arises. The deemed dividend is in a separate cycle  
c Directors fees | 30 000
<table>
<thead>
<tr>
<th>Description</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>117 000</td>
</tr>
<tr>
<td>- exempt, section 10(1)(hA)</td>
<td>-117 000</td>
</tr>
<tr>
<td>Dividend of R4 000 from Kiddies</td>
<td>4 000</td>
</tr>
<tr>
<td>- Exempt, section 10(1)(k)</td>
<td>-4 000</td>
</tr>
<tr>
<td><strong>TAXABLE INCOME</strong></td>
<td>30 000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Marks</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total marks available</td>
<td>3</td>
</tr>
<tr>
<td>Maximum marks available</td>
<td>3</td>
</tr>
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</table>