QUESTION 2 — 50 marks

1 Background information: Jodee (Pvt) Ltd

Jodee (Pvt) Ltd ('Jodee') is a company that produces ice cream that is sold in bulk to wholesalers and all its income is derived from such sales. Mr Joe Dee founded Jodee in 2004 when he started producing vanilla-flavoured ice cream. The product range has since expanded to include many varieties of cones, lollies, flavoured full-cream ice creams and coated ice creams, which are packaged in both cartons and tubs.

Jodee manufactures its ice creams in a leased factory. The owner of the premises is not a related party. The lease is an arms-length contract.

Jodee's products are distributed to most major cities of Zimbabwe, as well as the informal sector and hospitality industry. Joe attributes Jodee's success and its market position to being able to consistently deliver good quality ice cream at affordable prices.

Joe's son, Jonathan, recently graduated as an engineer and he is interested in becoming involved in the business. Jonathan feels that Jodee's current business model is outdated and is not responding to changing customer preferences. One of his suggestions is to introduce an online platform where customers can create their own ice cream flavours, pay via credit card and have their ice-cream delivered to their doorsteps.

Jonathan has been reading up on drone delivery systems. Delivery drones are small, remotely-operated aircraft carrying packages to a destination. He believes that, particularly in view of social distancing, the time has come to explore this alternative. Drone deliveries have the added advantage of speed, which is important for delivering ice cream. Jonathan felt this strengthened his case to get Joe to consider this opportunity. Joe has become increasingly open to Jonathan's ideas.

Jodee's revenue and profit after tax have been growing at 6% per annum during the past few years. The company's annual revenue was ZWL15 million in the 2019 financial year (FY2019). However, revenue declined to ZWL11 million in FY2020 due to decreased economic activity and disruptions as a result of Covid-19. Before the lockdown period the ice cream industry had been growing and companies similar to Jodee had annual revenue growth of around 11%.

Jodee is a Zimbabwean resident for tax purposes with a 31 December financial year end. Jodee's production process is considered to be a 'process of manufacture' by the Zimbabwe Revenue Authority (Zimra). Zimra does not recognise Jodee as a Small to Medium-Sized Entity. The Public Accountants and Auditors Board declared Zimbabwe to be a hyper-inflationary economy in October 2019. On 1 January 2019, Jodee changed its functional currency from United States dollars (USD) to Zimbabwe dollars (ZWL).

2 Existing finance structure of Jodee

Joe is the sole shareholder of Jodee and contributed the equivalent of current re-denominated ZWL8 million as consideration for acquiring all 800 issued ordinary shares of the company. Joe does not own any shares or interests in any other companies. The amount raised from Jodee's share capital issue was used to set up operations and to fund the initial working capital required by Jodee, and included the purchase of raw materials, rental of premises and employment of staff.

Jodee had obtained the following loans to fund the acquisition of equipment that is used in its production process:

2.1 Loan from Star Bank

A loan of ZWL5 million on 1 January 2019 on the following terms and conditions:

- Interest at an effective fixed rate of 10% per annum;
- The interest is calculated and paid at the end of each calendar month;
- The principal loan amount is repayable on 31 December 2028;
- The loan is subject to a covenant that the company's long-term debt to equity ratio may not exceed 50%; and
- Should the debt to equity ratio exceed this threshold, the loan becomes repayable immediately.

Star Bank is a Zimbabwean resident financial institution licensed under the Banking Act.

The loan was used to purchase equipment for Jodee's ice cream production process. The equipment was brought into use on 11 January 2019 and capital allowances on it (excluding value-added tax (VAT)) were claimed in terms of the Fourth Schedule of the Income Tax Act during the 2019 year of assessment.

2.2 Finance from Commercial Asset Financiers

Jodee purchased an industrial freezer for ZWL1 million (excluding VAT) that was brought into use on 1 October 2019. The purchase was financed by means of a credit facility obtained from Commercial Asset Financiers (Pvt) Ltd ('CAF') on the following terms and conditions:

- The credit facility bears interest at an effective fixed rate of 12% per annum;
- Interest is calculated and paid at the end of each month; and
- The principal amount is repayable on 1 October 2024.

CAF is a financial institution that provides finance to the productive sector and its operating model is to support risky ventures. CAF has previously converted debt to equity for its clients when necessary. CAF and Jodee are not associates as defined in the Income Tax Act.

The purchase of the industrial freezer coincided with the renewal of the factory lease. In negotiating the terms of the lease, it was agreed that the installation of the industrial freezer for a total cost of ZWL1 million was to be considered a fixed improvement to the leased land and buildings and that Jodee would be obligated to install the industrial freezer at his own cost. On legal early termination or expiry of the lease the industrial freezer would not be removed and would become the property of the landlord without any compensation to Jodee. These terms were set out in the new lease agreement which was entered into with effect from 1 October 2019. During the installation, it was found that the existing drainage was not adequate and Jodee decided to upgrade that at his own discretion and cost for an additional ZWL200 000. As the lease had been concluded when this became apparent, the additional upgrade was not agreed to in terms of the lease. The useful life of the industrial freezer is estimated at 20 years. The period of the new lease is 12 years, with an option to renew for a further 12 years. Based on this agreement, Jodee decided to amortise the total cost of the freezer over 12 years with no residual value.

Jodee claimed the full cost of the freezer as a capital allowance, and also the full cost of the modifications to the drainage as a capital allowance, in its income tax computation for the 2019 year of assessment.

3 Packaging equipment required

During the course of 2019, Jodee started negotiations with Eezycream, a fast food takeaway chain group in Zimbabwe. Eezycream requires Jodee to provide ice cream packaged specifically for this chain group. Jodee will have to purchase packaging equipment with an estimated cost of ZWL1,3 million to be able to fulfil this requirement.

The financial manager of Jodee, Ms Anida Pillay, prepared cash flow forecasts for evaluating the investment opportunity. Based on these forecasts, she is of the opinion that the packaging equipment should be purchased as it would add value to the company. An added benefit of the packaging machine is that it is versatile and would allow Jodee to consider various types of delivery, whereas the current packaging machine is only suitable for the current business model.

Negotiations were well under way and the deal was almost completed when takeaway restaurants were closed down as a result of the nationwide Covid-19 lockdown in 2020. After the restrictions were lifted and takeaway restaurants were allowed to re-open, the negotiations continued and an agreement was reached.

Jodee has two possible sources for the purchase of the packaging machine:

1. Jodee could purchase the packaging equipment from a local supplier at a cost of ZWL1,3 million, excluding VAT.

2. Jodee could import identical packaging equipment from the United States of America (USA) at a cost of USD70 000, at an expected exchange rate of USD1 : ZWL17. The cost includes shipping to Zimbabwe and this value is also the customs duty value of the equipment. Jodee would be liable for customs duty of ZWL100 000 if it decides to import the equipment.

Anida favours importing the packaging equipment since the company usually struggles for a long time to claim input tax on capital goods due to the audit and verification processes of Zimra.

4 Financing for packaging equipment

Jodee does not currently have the necessary funds to purchase the packaging equipment and will therefore need to obtain further finance. Jodee had a net asset value of ZWL13,55 million before making a decision regarding the financing of the packaging equipment.

Anida is worried about the impact that additional loan finance would have on the debt covenant relating to the loan from Star Bank and she has therefore negotiated the following proposal with CAF:

- The existing ZWL1 million loan with CAF will be converted into equity by Jodee issuing 200 ordinary shares for a 20% interest in the company. This share issue will be the full and final settlement of the existing loan;
- For the purposes of the proposed conversion of the CAF loan into Jodee shares, the market value per share in Jodee would be ZWL4 000. This would also be the market value immediately after the conversion; and
- CAF will provide further loan finance of ZWL1,3 million to fund the purchase of the packaging equipment.

Joe has some concerns about the proposal and asked the financial manager to explore other sources of finance. Anida came across an article in *MoneyGuru*, a leading financial magazine, regarding finance for small and medium-sized enterprises. The following paragraph on private equity caught her attention:

> Private equity funding is certainly more hands-on than shareholders in a listed business. Generally, private equity companies are in contact with their management teams and their executives on at least a monthly basis. While they are not the management team who is running the business, they are nevertheless very active shareholders. They drive the strategy and confer with management on what to do and what not to do. The hands-on aspect is very prominent.

After reading the article, Anida widened her search for other sources of finance. In her research, she came across another *MoneyGuru* article which mentioned several sources of finance for small- and medium-sized enterprises. She identified crowd-funding, angel investors and venture capital as potential sources of finance for Jodee. She extracted the following from the article:

Crowd-funding

The next category is crowd-funding … when looking for R1 000, R100 000 or R1 million, instead of going to one person and asking for that whole amount, crowd-funding allows you to use personal connections or a platform to secure money from a number of people. There are two typical ways: the first is an informal request to several family members and friends to each invest a relatively small portion of the total investment required; the second is using a formal crowd-funding platform on which you request support from a user base by describing your business and various objectives (business, social, environmental, etc.) and users then decide if your business is something that they want to invest in and support …

Angel investors

Angel investors are a select few individuals (typically high net-worth individuals) who are looking for opportunities and ideas in which they can invest. They are not people necessarily known to the business owners, but they want to invest either to support businesses, or speculatively invest in the future profit potential of the opportunity.

Venture capital funds

Then we have venture capital (VC) investors seeking to invest in early-stage businesses that have high growth potential and an ability to grow into significant revenue-generating enterprises. VC investment is highly risky but the returns have proven to be spectacular in a few cases. These are sometimes referred to as unicorns and two of the best-known VC successes are Google and YouTube.

INITIAL TEST OF COMPETENCE, APRIL 2021

PROFESSIONAL PAPER 1

PAPER 1 QUESTION 2 – REQUIRED		**Marks**	
	PAPER 1 QUESTION 2 – REQUIRED	**Sub-total**	**Total**
(a)	Discuss under what circumstances the interest paid to Star Bank on the loan would be deductible by Jodee for income tax purposes.	4	4
(b)	Discuss – (i) what the Income tax consequences would be for Jodee if it opts to convert the existing loan from CAF into 200 ordinary shares;	5	
	(ii) the appropriateness of the income tax treatment adopted by Jodee in respect of the industrial freezer and the modifications to the sewerage system; and	8	
	(iii) the income tax consequences to the landlord in respect of the purchase and installation of the industrial freezer by Jodee.	5	18
(c)	Critically discuss, supported by calculations, whether you agree with Anida's preference for importing the packaging equipment from the USA.	13	
	Communication skills – logical argument	*1*	14
(d)	Discuss, with regard to the financing options available to Jodee for the packaging equipment – • Anida's negotiated proposal with CAF, supported by calculations where relevant; and • the factors that Jodee should take into account in deciding on the appropriate funding for the packaging equipment, considering alternatives with reference to the financing options identified in the two *MoneyGuru* article extracts.	13	
	Communication skills – presentation	*1*	14
Total			**50**