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TAX

Landmark case on treatment of trading stock

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INTRODUCTION

At about this time last year I wrote an article in relation to a decision of the Port Elizabeth Tax Court (case number 13539/13673), which found in favour of the taxpayer, and which appeared to close the gap between the valuation of closing stock under section 22 of the Income Tax Act, 1962 (the Act), and for accounting purposes under IFRS.

SARS successfully appealed to the Supreme Court of Appeal (see: *SARS v Volkswagen SA Proprietary Limited* (1028/2017) [2018] Zasca 116 (19 September 2018)), which handed down its judgement on 19 September 2018. But, as will be seen later, the SCA found further than merely disagreeing with the Tax Court, and has effectively changed the rules which have universally been applied for nearly 100 years.

WHERE ARE THE DIFFERENCES?

The problem has never been related to the determination of the cost of stock. Section 22 of the Act requires that trading stock must be brought to account at the cost price, and it goes on to state that this includes the costs incurred, whether in the current or any prior tax year, in acquiring the trading stock, plus any further costs incurred by the person in terms of IFRS (in the case of a company) in getting the trading stock into its then existing condition and location.

The reference to IFRS is relatively recent, but the section has for many years included the requirement to include costs in getting the trading stock into its then existing condition and location.

This formulation is almost identical to that required under IFRS.

Where the difference arises is in the writing down of the inventory or trading stock. IFRS requires that inventory must be carried at the lower of cost and net realisable value (NRV) which, insofar as is relevant to the judgment, was defined in accounting statement IAS 2 as "the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale". On the other hand, section 22 of the Act requires the trading stock to be carried at cost "less such amount as the Commissioner may think just and reasonable as representing the amount by which the value of such trading stock has been diminished by reason of damage, deterioration, change of fashion, decrease in the market value or for any other reason satisfactory to the Commissioner".

It will be seen that these are two very different sets of criteria. Secondly, it will be noted that the Act grants the Commissioner a discretion as to how much may be deducted from the cost (though not whether there is an entitlement to the deduction in the first place), and the Commissioner's decision is subject to objection and appeal. On appeal, the court is entitled to exercise its own independent discretion and substitute its decision for that of the Commissioner's.

THE TAX COURT'S ANALYSIS

In the previous article, I examined the Tax Court's analysis in some detail, but it is not necessary to do so again here. What is necessary is to give a brief outline of the analysis, in order to set the context for the SCA's decision.

The Tax Court concluded that section 22 of the Act sets out what needs to be done, namely to bring to account the cost at cost price less appropriate allowances for reduction in market value, changes in fashion, damage, etc., but it does not indicate how these values must be

determined.

On the other hand, the relevant IFRS statements seek to achieve the same objective, and they do indicate how this is to be achieved. The Tax Court thus concluded that the arriving at the net realisable value (NRV) for IFRS purposes is an appropriate method to determine the value of trading stock for tax purposes.

THE SCA'S DECISION

At this point it will be noted that the requirement under section 22 of the Act is to bring the stock to account at cost less the allowance for diminution in value. As indicated, cost is the actual cost plus further costs under IFRS in getting the trading stock into its then existing condition and location.

On the other hand, under IFRS, in arriving at NRV it is also necessary to make an allowance for certain costs to be incurred after the year end, such estimated costs to completion, selling costs, and the like.

The SCA held that the clear wording of section 22 is such that its language is couched in the past tense. Consequently, one can only look at events that have occurred prior to the year end to determine whether the value of stock has diminished, and the section is not concerned what might happen to stock in the future (with which IFRS does concern itself).

Thus, for example, the goods must already have been damaged or have deteriorated in condition, or the change in fashion must already have occurred by the end of the year. In the case of a decrease in market value the allowance can be given in two circumstances: the first where an event has occurred in the tax year causing the value to diminish. The second is where it is known with reasonable certainty that an event will occur in the following year that will cause the value of trading stock to diminish. The example of the latter was that there is knowledge that a glut had built up in the market for a perishable commodity, where the glut would ensure in future a decline in the price (the price might only decline in the future, but the glut, i.e. the cause, had already occurred).

It follows that, insofar as the taxpayer's stock was reduced by an allowance for these future costs, e.g. future selling costs, and the Commissioner had refused to allow this deduction, the SCA upheld the Commissioner's contention.

Allowing future costs to be taken into account as a deduction against the value of trading stock was, it was held, inconsistent with the basic deduction provisions under section 11(a) of the Act, that what may be deducted in a tax year is expenditure and losses actually incurred in the production of income – applying IFRS allows a taxpayer to deduct in the current year expenses that will be incurred in the following year.

THE DEPARTURE FROM LONGSTANDING PRACTICE

It was noted by the SCA that IFRS requires that NRV must be determined item by item, unless it is impractical. The court stated that in that way "any shortfall likely to arise when the stock item is sold is identified and accounted for immediately, but no account is taken of surpluses that are likely to be realised on other stock items when they are sold. That prevents the trader from claiming profits in respect of sales that have not yet taken place".

The court then went on to state the following at paragraph 46:

"While understandable from an accounting point of view, from a taxation perspective there are problems with this approach. The fiscus is concerned with the value of trading stock ***as a whole***. Writing down the value of part of the stock to NRV ***ignores the fact that the NRV of the remaining stock is higher than cost to price***.... Using NRV is a legitimate approach from an accounting perspective. However, I can see no reason for the Commissioner to accept that Volkswagen's trading stock had diminished in value on the basis of a calculation where Volkswagen took advantage of the 'swings', where the NRV was lower than cost price, ***but disregarded the 'roundabouts', where the reverse was true***. For tax purposes the ***question was*** whether the ***Volkswagen's trading stock as a whole had suffered a diminution in value***." (My emphasis.)

As I read it, the following is the effect of this paragraph. Assume that a company has closing stock with a cost of R1 000. Of this amount, R300 has suffered damage or deterioration, and its market value is only R200. The remaining R700 can be sold at double its cost price i.e. R1 400. The following illustrates the change:

- Historically, one would have brought to account the stock costing R300 at the market value of R200, plus the balance of R700 at cost, giving a total value for the purposes of section 22 of the Act at R900.

- Now what that paragraph says is that the total cost is R1 000, and the total market value is R200 + R1 400 = R1 600, and thus the stock must be brought to account at R1 000. The reason is that as a whole there is no diminution in value and one must take into account both the swings and the roundabouts.

It remains to be seen how fervently SARS pursues this aspect of the decision of the SCA. Bearing in mind SARS's current hunger for collections.



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