

# TAX & EXCHANGE CONTROL ALERT

## IN THIS ISSUE

### IMPORTANT JUDGMENT FOR TAXPAYERS REGARDING THE VALUATION OF TRADING STOCK

In *C:SARS v Volkswagen SA (Pty) Ltd* (1028/2017) [2018] ZASCA 116 (19 September 2018) the Supreme Court of Appeal (SCA) dealt with important principles in the Income Tax Act, No 58 of 1962 (Act), specifically s22 of the Act dealing with amounts to be taken into account in respect of trading stock. The judgment will likely have far-reaching consequences for many taxpayers and this article provides a brief analysis of the key issues and principles underpinning the judgment.

# IMPORTANT JUDGMENT FOR TAXPAYERS REGARDING THE VALUATION OF TRADING STOCK

The key issue centred around the interpretation and application of s22 of the Act.

In the Volkswagen case, the Taxpayer contended that it was entitled to reflect the value of its trading stock at less than cost as per s22(1)(a) of the Act.



In *C:SARS v Volkswagen SA (Pty) Ltd* (1028/2017) [2018] ZASCA 116 (19 September 2018) the Supreme Court of Appeal (SCA) dealt with important principles in the Income Tax Act, No 58 of 1962 (Act), specifically s22 of the Act dealing with amounts to be taken into account in respect of trading stock. The judgment will likely have far-reaching consequences for many taxpayers and this article provides a brief analysis of the key issues and principles underpinning the judgment.

In *C:SARS v Volkswagen*, the task before the court was to determine whether the Net Realisable Value (NRV) of Volkswagen South Africa's (Taxpayer) trading stock, calculated in accordance with International Accounting Standard 2 (IAS2) of the International Financial Reporting Standards (IFRS), may and should, where such NRV is lower than the cost price of such trading stock be accepted as representing the value of trading stock held and not disposed of at the end of the respective years of assessment for purposes of s22(1)(a) of the Act.

## The Issue

Section 22 of the Act in its simplest form is a timing provision which ensures that the cost of trading stock in the hands of a taxpayer matches the income earned in respect of that trading stock sold, or otherwise disposed of.

In this particular instance, the SCA had to consider s22(1)(a) of the Act which in essence sets out the general rule pertaining to closing stock held and not disposed of which must be included in the income of a taxpayer at the end of the year of assessment. In essence, the closing stock to be included in the income of a taxpayer is the cost price of the trading stock, 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 market value or for any other reason satisfactory to the Commissioner.

In the *Volkswagen* case, the Taxpayer contended that it was entitled to reflect the value of its trading stock at less than cost as per s22(1)(a) of the Act. The contention made on behalf of the Taxpayer was that it should be entitled to do this on the basis of its NRV of its trading stock calculated in accordance with IAS2, in that its NRV reflected that the value of its trading stock had diminished.

Importantly, for purposes which will become more apparent later, the Taxpayer's trading stock *in casu* constituted a number of unsold vehicles including trucks, busses and passenger vehicles. Furthermore, given that NRV is defined as the estimated selling price of inventory in the ordinary course of business, less the estimated costs of completion and the estimated costs necessary to make the sale, the individual categories of costs taken into account in determining the NRV of its trading stock were described generally as rework/refurbishment costs;

# IMPORTANT JUDGMENT FOR TAXPAYERS REGARDING THE VALUATION OF TRADING STOCK

CONTINUED

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outbound logistics; marine insurance; sales incentives; distribution fees; warranty costs, costs relating to the Audi Freeway Plan and the Volkswagen AutoMotion Plan and roadside assistance costs.

#### **SCA's interpretation of s22(1)(a) of the Act**

The SCA commenced with its interpretation of the relevant provisions of s22 of the Act and provided examples of what is contemplated in s22(1)(a) at paragraphs [14] and [15] as follows:

Four circumstances namely, damage, deterioration, change of fashion or decrease in market value, are specified as causing a diminution in the value of trading stock. All of those can be illustrated quite simply. Goods may be damaged in transit and as a result can only be sold at less than cost. Their condition may deteriorate whilst in transit or in storage, as with a cargo of first grade rice undergoing heating at sea, so that it has to be downgraded to second or third grade and is only saleable at less than cost. Fashionable clothing tends to be seasonal and, if not sold before the end of the season,

retailers may need to dispose of unsold surplus stock at discounted prices below cost. A decrease in the value of trading stock may arise where stock has been acquired at a particular price and the supplier subsequently reduces the price. For example, a retailer might acquire mobile phones for R400 from the manufacturer. If the manufacturer cuts its price to retailers to R300, in order to get rid of stock before introducing a new model phone, the value of the stock acquired at R400 has diminished.

The section contemplates the possibility of there being other reasons for a diminution of value apart from the four it specifies. For that reason it empowers the Commissioner to make a just and reasonable allowance to accommodate a diminution in value of trading stock for any other reason that may be satisfactory to the Commissioner.

Wallis JA thereafter held that what is important is that the wording of s22 dictates that one must ordinarily look back at what happened in the year of assessment

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# IMPORTANT JUDGMENT FOR TAXPAYERS REGARDING THE VALUATION OF TRADING STOCK

CONTINUED

*The correct position, as Wallis JA put it, was that the Commissioner can only grant a just and reasonable allowance in respect of diminution in value of trading stock under s22(1)(a) in two circumstances.*



under consideration given that the language is couched in the past tense. The section is thus not strictly concerned with what may occur in the future, albeit that there is nevertheless an element of futurity.

The correct position, as Wallis JA put it, was that the Commissioner can only grant a just and reasonable allowance in respect of diminution in value of trading stock under s22(1)(a) in two circumstances, namely:

- where some event has occurred in the tax year in question causing the value of the trading stock to diminish; and
- where it is known with reasonable certainty that an event will occur in the following tax year that will cause the value of the trading stock to diminish. An example given by Wallis JA in this regard was one of simple supply and demand microeconomics, namely where there may be knowledge on the part of the taxpayer that an excess supply had built up in the market for a perishable commodity, where that oversupply would ensure a marked, certain and unavoidable decline in the price of that commodity in the following year.

Another important aspect of Wallis JA's judgment was that the cost price of the goods, and not the actual or anticipated market value on disposal, should be the benchmark against which any diminution in value should be allowed. Wallis JA went on to conclude that what is required is the presence of known events during the year in question (or events that will occur with reasonable certainty in the following year)

which have led to the cost price of the goods ceasing to be the proper measure of their value.

Having established the views of the court regarding the interpretation and application of s22(1)(a) of the Act in general terms, Wallis JA then proceeded to consider the Taxpayer's arguments and submissions against this background, with specific reference to the Taxpayer utilising NRV as calculated in accordance with IAS2 to value its trading stock at year end.

## Discussion of issues and judgment

Having considered and discussed the relevant aspects of NRV as calculated in accordance with IAS2 and with specific reference to the Taxpayer's submissions, Wallis JA held at paragraph [43] as follows:

There is obvious scope for an overlap between the provisions of s22(1)(a) and those of IAS 2. The former refers to a diminution of value of trading stock caused by damage, deterioration, change of fashion, or decrease in market value. Clause 28 of IAS 2, quoted above in para [35], records that the cost of inventories may not be recoverable if they have been damaged or have become obsolete in whole or part. To that extent the two correspond. But the other elements to which IAS 2 refers do not relate to the same matters as s22(1)(a). They are concerned with future matters such as changes in likely selling prices, or increases in the estimated costs of completion or the estimated costs of making sales.

# IMPORTANT JUDGMENT FOR TAXPAYERS REGARDING THE VALUATION OF TRADING STOCK

CONTINUED

*There is no doubt that the judgment will have a far reaching and profound affect in respect of how Taxpayers and SARS consider, interpret and apply the provisions of s22(1)(a) of the Act.*



Wallis JA proceeded to raise several practical difficulties in accepting the Taxpayer's method, including that writing down the value of part of the stock to NRV ignores the fact that NRV of the remaining stock is higher than cost price and that it would leave the Commissioner with little scope for assessing the legitimacy of a calculation relating in its entirety to the future trading circumstances of a taxpayer.

In addition to the practical difficulties discussed, Wallis JA, in upholding the appeal and finding in favour of the Commissioner, held that the utilisation of NRV within this context was inconsistent with two basic principles of the Act. First, that NRV was patently forward looking whereas the concept of taxation is backward looking and therefore incompatible. Secondly, that by using NRV within this context, expenses incurred in a future year of assessment in respect of income earned in that succeeding year become deductible prematurely in a prior year (ie timing mismatch).

#### Observations

There is no doubt that the judgment will have a far-reaching and profound impact in respect of how Taxpayers and SARS consider, interpret and apply the provisions of s22(1)(a) of the Act. The key

question, however, is the extent to which the judgment can be applied in matters of this nature. It should be appreciated that the SCA was presented with a specific set of facts which may ultimately result in the judgment having, to some extent, limited application.

For instance, "trading stock" as defined in s1 of the Act contemplates three separate categories of trading stock. In the *Volkswagen* case, the SCA was tasked with broadly considering the first two categories of trading stock namely anything that is produced, manufactured, or acquired for the purposes of sale or exchange or anything, the proceeds on disposal of which, form part of the gross income of the taxpayer. In broad and simple terms, therefore, stock which is ultimately acquired or produced in order to ultimately sell or otherwise dispose of.

The SCA, however, was not tasked with considering the application of s22(1)(a) of the Act within the context of the altogether different third category of trading stock, namely consumable stores, and spare parts acquired by a taxpayer to be used or consumed in the course of the taxpayer's trade. This category of trading stock is not within the realm of the usual trading stock contemplated and is used in a



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# IMPORTANT JUDGMENT FOR TAXPAYERS REGARDING THE VALUATION OF TRADING STOCK

CONTINUED

*The application, interpretation and effects of this judgment will certainly be interesting to observe in the coming years.*



taxpayer's production process as opposed to for resale purposes and one may thus argue that the *Volkswagen* case should be applied with a measure of caution to the calculation of the diminution in value of this category of trading stock, given its distinct features.

A further important aspect to note from the judgment is the general discussion of accounting principles and their application to South African tax law concepts. Since time immemorial, there has been robust discussion regarding the use and application of accounting principles within

tax law. While Wallis JA was clear that one must apply accounting principles with caution to interpretational difficulties within tax law, upon careful reading of the judgment one may nevertheless argue that Wallis JA stopped short of completely discarding the value and benefit of accounting principles in ascertaining the reasonability of tax positions taken by taxpayers in specific circumstances.

The application, interpretation and effects of this judgment will certainly be interesting to observe in the coming years.

*Jerome Brink*

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