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TAX & EXCHANGE CONTROL **ALERT**

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Methods used by taxpayers to write down trading stock to be rewritten?

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Customs & Excise Highlights

This week's selected highlights in the Customs & Excise environment since our last instalment.

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CDH
CLIFFE DEKKER HOFMEYR

Methods used by taxpayers to write down trading stock to be rewritten?

The 2019 Draft Taxation Laws Amendment Bill proposes a key amendment to the manner in which taxpayers can write trading stock down at the end of any year of assessment which will have far-reaching implications for many taxpayers.

In its simplest form, s22 of the Income Tax Act, 58 of 1962 (Act) 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. The 2019 Draft Taxation Laws Amendment Bill (2019 Draft TLAB) proposes a key amendment to the manner in which taxpayers can write trading stock down at the end of any year of assessment which will have far-reaching implications for many taxpayers.

Background

Section 22(1)(a) of the Act 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 of SARS (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.

Given the wide discretion afforded to SARS in this respect, SARS's Practice Note No. 36 issued on 13 January 1995 (Practice Note 36) provides some guidance on the subject. Practice Note 36 quotes with approval an extract from *ITC 1489* 53 SATC 99, wherein it was held, amongst others:

- That if a method of reducing the cost of stock by a percentage is adopted (because, for example, it is impractical to value individual items of stock), the percentage reduction should not only be supported by trading history and, where appropriate, post-balance sheet experience, but the Commissioner should be told how that percentage is arrived at.
- That the Commissioner has to exercise a discretion with regard to the amount by which the value of trading stock has been diminished and cannot exercise that discretion if he is not told on what basis the accounts submitted to him have been prepared; hence the Act, by implication, requires such a disclosure.

Practice Note 36 concludes that where stock is written off on a fixed, variable or any other basis (not representing the actual value by which it has been diminished) that may be acceptable to the Commissioner to the extent that a taxpayer can provide reasonable justification for such method.

Methods used by taxpayers to write down trading stock to be rewritten?*...continued*

The critical issue is that Practice Note 36 and the previous case law on the matter accepts that it may be impractical to value individual items of stock and thus a taxpayer may utilise an alternative method so long as suitable justification for utilising that method can be provided.

The critical issue is that Practice Note 36 and the previous case law on the matter accepts that it may be impractical to value individual items of stock and thus a taxpayer may utilise an alternative method so long as suitable justification for utilising that method can be provided. In particular, while one may for example be able to value stock on an item-by-item basis where one only has ten items of such stock that will ultimately be sold (eg aeroplanes), the matter is altogether different where the items of stock run into the thousands. For instance, the third category in the definition of "trading stock" includes consumable stores, and spare parts acquired by a taxpayer to be used or consumed in the course of the taxpayer's trade. This includes such specific items as nuts and bolts which would likely be very difficult to value on an item-by-item basis.

Proposed changes to diminution in value of closing stock

Notwithstanding the guidance on the matter and previous case law, the 2019 Draft TLAB now proposes that any diminution in the value of trading stock must be determined on an item-by-item basis. Section 22 of the 2019 Draft TLAB states that s22 of the Act is to be amended by the addition to ss(1) of the following proviso:

> ": Provided that for the purposes of this subsection:
>
> (a) the amount of trading stock must be taken into account in determining taxable income by including such amount in gross income; and
>
> *(b) any diminution in the value of trading stock must be determined on an item-by-item basis."*
> [Our emphasis]

Reasons for the change

Curiously, the draft Explanatory Memorandum on the 2019 Draft TLAB (Memorandum) does not appear to clarify nor explain the rationale for the proposed change and is altogether silent on the proposal, despite various issues that arise. First, such an amendment will have far-reaching implications and ramifications for taxpayers given the various impracticalities already discussed above. This is notwithstanding the fact

Methods used by taxpayers to write down trading stock to be rewritten?...*continued*

The proposed amendments are still in draft form and it is anticipated that there will be various submissions made to National Treasury and SARS on this proposed amendment as well as extensive discussions during the relevant public engagement on the 2019 Draft TLAB.

that previous case law has accepted that the diminution of trading stock on an item-by-item basis can be impractical. Second, it represents a substantial shift in policy given the guidance in Practice Note 36. Lastly, there is no explanation as to what is meant by "item-by-item" and whether this includes categories of items or rather each and every item down to the last nut and bolt.

Furthermore, s22(1)(a) of the Act already has a pending amendment wherein the entire s22(1)(a) is to be substituted by s37(1)(a) of the Taxation Laws Amendment Act, 25 of 2015 with effect from a date yet to be determined. This amendment will remove the discretion afforded to the Commissioner in the provision and provide for a mechanism wherein the Commissioner will instead publish, by way of public notice, the additional reasons giving rise to the diminution in value of trading stock. This amendment is in accordance with the policy decision to remove the various discretions afforded to the Commissioner in the various tax Acts while moving to more objective tests and provisions. It is thus interesting that the proposal in the 2019 Draft TLAB has arisen prior to the promulgation of the new proposed substitution of s22(1)(a) of the Act.

Conclusion

The proposed amendments are still in draft form and it is anticipated that there will be various submissions made to National Treasury and SARS on this proposed amendment as well as extensive discussions during the relevant public engagement on the 2019 Draft TLAB. It will be interesting to monitor developments in the coming months given the wide ramifications this will have for many taxpayers.

Jerome Brink

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Customs & Excise Highlights

In the event that specific advice is required, kindly contact our Customs and Excise specialist, Director, Petr Erasmus.

This week's selected highlights in the Customs & Excise environment since our last instalment:

1. Amendments to the Rules to the Customs & Excise Act, 91 of 1964 Act (Act) (certain sections quoted from the SARS website):

   1.1 On 8 August 2019, the substitution in item 202.00 for form DA 1 – Report inwards/ outwards for ships.

2. New authority case law (certain sections quoted from the judgment):

   2.1 Acti-Chem SA (Pty) Ltd // CSARS, Case No: 8540/2017 in the High Court of South Africa, Kwazulu-Natal Division, Pietermaritzburg. We quote from the judgment, delivered by Gorven J on 15 August 2019, in relation to a rebate item in Schedule 3 to the Act:

   "The applicant contends that it is entitled to a rebate on goods imported by it … The rebate item in question is item 306.07 of Schedule 3 to the Act. This concerns '[p]repared waxes, not emulsified or containing solvents.' The industry under which it is listed is 'Polishes and Creams' (the industry) … Following an inspection of the applicant's books and documents in September 2013, the respondent (the Commissioner) issued a determination letter dated 25 February 2014.This asserted that the imported goods had been used 'otherwise than in accordance with the item under which entry was intended for.'

   .....

   And s75(2)(a) provides:

   'A rebate of duty in respect of any goods described in Schedule No. 3 shall be allowed:

   a) only in respect of goods entered for use in the production or manufacture of goods in the industry and for the purpose specified in the item of the said Schedule in which those goods are specified.'

   .....

   The relevant note to Schedule 3 reads:

   'The imported goods . . . shall . . . be admitted for use in connection with the production or manufacture of goods in the industries specified . . .'

   The imported goods must accordingly be used 'in connection with the production or manufacture of goods' in the industry.

   .....

   The imported goods are AC 540, an Ethylene-Acrylic Acid Copolymer and AC 673P, an Oxidised Polyethylene Homopolymer (the imported goods). The products manufactured by the applicant using the imported goods are Quecolin ESP and Quecolin HW1 (Quecolin). Neither of these is a polish or cream. They can be used in the manufacture of polishes or creams. The applicant does itself not use them to do so. They can also be used to manufacture goods other than polishes or creams.

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Customs & Excise Highlights...*continued*

In the event that specific advice is required, kindly contact our Customs and Excise specialist, Director, Petr Erasmus.

.....

The failure to specify under the heading 'Polishes and Creams' that the imported goods under discussion must be used for a particular product within that industry does not mean that they need not be used in the industry, only that any product which is a product or cream is acceptable.

.....

In my view, the phrase 'in connection with' simply means that the initial importer need not itself manufacture polishes or creams from the imported goods. This can be done by a subsequent entity. However, the manufacture of polishes or creams from the imported goods is necessary before it can be said that they have been used 'in connection with the production or manufacture of goods in the [industry]'.

.....

If Quecolin is used by others to do so, the applicant's use is one 'in connection with' the manufacture of polishes or creams. I accordingly find that the manufacture of Quecolin without more does not qualify the applicant for the relevant rebate. It must ultimately be used to manufacture polishes or creams in order to do so.

.....

The question, then, is whether the 'predominant use' of Quecolin in the polishes and creams industry is sufficient ...

In the first place, the wording of the present provision does not support this interpretation. If that were intended, the note would presumably read 'for predominant use' and not simply 'for use'. Secondly, the clear purpose of the rebate is to promote the polishes and creams industry. This seems to me to require that the imported goods are ultimately used to manufacture polishes or creams. If this were not so, the rebate would not serve its purpose.

.....

Since the applicant does not manufacture polishes and creams from Quecolin, this must ultimately be done by a subsequent entity for the rebate to apply.

.....

The language of the provisions, the context of granting the Commissioner the powers in question and the purpose of rebates being to promote the industry all coalesce to show that the ultimate, exclusive use of the imported goods must be for the manufacture of polishes or creams. Also, that the polishes and creams must be manufactured by a rebate registrant ... Since the applicant does not manufacture polishes and creams and the entities to which the applicant sells Quecolin are not rebate registrants, the rebate claimed by the applicant does not apply".

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Customs & Excise Highlights...*continued*

The relevant rebate item, being the subject of the judgment, provides as follows:

"

306.07	...	INDUSTRY: POLISHES AND CREAMS	
306.07	...	Prepared waxes, not emulsified or containing solvents	Full duty

".

The judgment therefore confirms that even in the event of the relevant rebate item (above quoted part not in bold) does not specify which exact product must be manufactured from the imported product, the products described in the Industry section (above quoted part in bold) of the item must be manufactured in accordance with the quoted sections of the Act and the notes to the Schedule.

3. Amendments to Schedules to the Act (certain sections quoted from the SARS website):

   3.1 Regarding Schedule 1 Part 1, the substitution of tariff subheadings 7210.11, 7210.12.10, 7210.12.90 and 7212.10, to increase the rate of customs duty on tinplate from free of duty to 10%.

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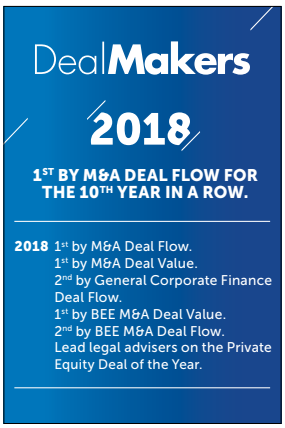
Petr Erasmus



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Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 1 BBBEE verification under the new BBBEE Codes of Good Practice. Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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