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TAX & EXCHANGE CONTROL **ALERT**

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Supreme Court of Appeal confirms its decision regarding trading stock obsolescence

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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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CLIFFE DEKKER HOFMEYR

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Supreme Court of Appeal confirms its decision regarding trading stock obsolescence

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There have been various jurisprudential and legislative developments over the past 12 months regarding section 22 of the Income Tax Act 58 of 1962 (Act), which, 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. We previously wrote about the Supreme Court of Appeal (SCA) judgment handed down last year in *C:SARS v Volkswagen South Africa (Pty) Ltd* 81 SATC 24 as well as the proposed amendments to section 22 that were published for public comment on 21 July of this year. In this alert we discuss the most recent judgment handed down by the SCA on the same issue on 27 September 2019 in *C:SARS v Atlas Copco South Africa (Pty) Ltd* (834/2018) [2019] ZASCA 124.

Background

Section 22(1)(a) of the Act in essence provides that 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' 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.

Practice Note 36 further 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 acceptable to the Commissioner to the extent that a taxpayer can provide reasonable justification for such method.

Supreme Court of Appeal confirms its decision regarding trading stock obsolescence...*continued*

SARS, however, took the view that the write down of stock by the taxpayer did not comply with the provisions of section 22(1)(a) of the Act and assessed the taxpayer accordingly.

The judgment in *C:SARS v Atlas Copco* provides and summarises some of the critical views of the SCA on the matter including summarising five critical aspects of the views expressed by Leach J in the *Volkswagen* case. Ponnan JA (with reference to various authorities) commented as follows at paragraph [7]:

> *Section 22(1)(a) is concerned with the value of the trading stock of a taxpayer as trading stock at year end. It empowers SARS to allow a deduction from the cost price, by way of a just and reasonable allowance, in the four circumstances specified namely, damage, deterioration, change of fashion or decrease in market value or for any other reason satisfactory to the SARS. The rationale for the existence of these provisions 'is neither far to seek nor difficult to comprehend'. The section is couched in the past tense. It is concerned with an enquiry as to whether a diminution in value has already occurred. In other words, the cost price must already have diminished. The circumstances expressly mentioned in the section relate to a diminution of value as a result of events occurring prior to the rendition by the taxpayer of its tax return. The exercise is thus one of looking back at what happened during the tax year in question.*

Taxpayer's method of writing down trading stock *in casu*

In *C:SARS v Atlas Copco*, the taxpayer was a member of the Atlas Copco Group (Group), with its parent company in Sweden. The main business of the taxpayer was to sell or lease – and thereafter service – machinery and equipment (including spare parts and consumables) that were imported mainly from Sweden, for use in the mining and related industries in South Africa. The taxpayer's parent company had conceived a policy known as the Finance Controlling and Accounting Manual (FAM) or The Way We Do Things (WAY), which was implemented and applied by all companies within the Group. In terms of the policy, the taxpayer was to write down the value of its closing stock by 50%, if such closing stock had not sold in the preceding 12 months, and by 100% if it had not sold in 24 months.

The taxpayer applied the policy by writing down its closing stock (separated into six categories) by the fixed percentages reflected in the policy. In its 2008 and 2009 tax returns it included the amounts it claimed the value of its trading stock had diminished by during those years of assessment. SARS, however, took the view that the write down of stock by the taxpayer did not comply with the provisions of section 22(1)(a) of the Act and assessed the taxpayer accordingly.

CLIFFE DEKKER HOFMEYR

Supreme Court of Appeal confirms its decision regarding trading stock obsolescence...*continued*

The Commissioner for SARS appealed against the tax court judgment and the matter was heard in the SCA after the SCA had already handed down the judgment in respect of a similar set of issues in *C:SARS v Volkswagen*.

The Tax Court initially upheld the appeal by the taxpayer against the additional assessments. In upholding the appeal, the Tax Court held that the net realisable value (NRV) of the taxpayer's closing stock for 2008 and 2009, calculated in accordance with International Accounting Standard 2 (IAS2), International Financial Reporting Standards (IFRS), SA Generally Accepted Accounting Practices (GAAP) and the policy (which policy was in line with IAS2 and IFRS), may and should, where it 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 relevant years for purposes of section 22(1)(a) of the Act.

The Commissioner for SARS appealed against the tax court judgment and the matter was heard in the SCA after the SCA had already handed down the judgment in respect of a similar set of issues in *C:SARS v Volkswagen*.

Decision of the SCA in *C:SARS v Atlas Copco*

Prior to handing down the judgment, Ponnan JA initially applied the five principles laid down by Leach J in *C:SARS v Volkswagen* to the six different categories of trading stock held by the taxpayer and commented generally on the taxpayer's contentions as follows [at para 12]:

> *It is difficult to discern the basis on which the taxpayer contended for a diminution of the value of its trading stock. That is because its version migrated from an initial reliance on a deemed obsolescence to reliance on a group policy in accordance with IAS2. The taxpayer did not suggest that there has been a diminution by reason of 'damage, deterioration, change of fashion [or] decrease in the market value'. It appears to be simply contending that because the items in question had remained on its shelves for a particular length of time, it was entitled to write down those items by fixed percentages by applying IAS2 to determine a new NRV and create provision for obsolescence.*

In concluding that the judgment of the Tax Court stood to be set aside, Ponnan JA held as follows at para [22]:

> *It is apparent when the evidence relating to all six categories [of trading stock] is considered, that the taxpayer's approach essentially boiled down to this: because it held thousands of items of stock at year end, it was not feasible for it to individually value each item. For that reason, it applied its policy with reference to item descriptions. This evidence was accepted by the Tax Court in support of the proposition that the legislature could not have intended that a trader assess each individual item of closing stock in circumstances where they hold thousands of items of trading stock. But this was misplaced. SARS never contended that the taxpayer had to assess each individual item of stock. On the contrary, as SARS accepted, the practice of sampling in these situations is a well-recognised method of dealing with the challenges of high volume trading stock. But, that is not what the taxpayer did in this instance.*

Supreme Court of Appeal confirms its decision regarding trading stock obsolescence...*continued*

The new revised proposed amendment is different to the initial proposed amendment and it will be interesting to consult the revised explanatory memorandum to be issued in due course in order to gauge the rationale for the new proposal.

Observation

The taxpayer in this case raised similar arguments to the taxpayer in *C:SARS v Volkswagen* and it is interesting to note that the matter proceeded to the SCA notwithstanding that the matter was heard after the SCA handed down the judgment in *C:SARS v Volkswagen*. The SCA in *C:SARS v Atlas Copco* confirmed its findings as per the *Volkswagen* case and while the court's findings do not require taxpayers to value each and every item individually, there needs to be a method to writing down its stock and a taxpayer should be able to substantiate this method sufficiently. This is in accordance with the guidance provided in Practice Note 36 and the general practical methods accepted by SARS in the past.

In respect of the initial proposed amendments to section 22 (which deviated from the above principles), the Minister of Finance tabled the revised draft Taxation Laws Amendment Bill, 2019 in Parliament on 30 October 2019. The proposed clause 24 reads as follows:

(1) Section 22 of the Income Tax Act, 1962, is hereby amended by the addition in subsection (1) to paragraph (a) of the following proviso:

''Provided that for the purposes of this subsection—

(i) the amount of trading stock must be taken into account in determining taxable income by including such amount in gross income; and

(ii) in determining any diminution in the value of trading stock, no account must be taken of the fact that the value of some items of trading stock held and not disposed of by the taxpayer may exceed their cost price; and''.

(2) Subsection (1) comes into operation on 1 January 2020 and applies in respect of years of assessment commencing on or after that date.

The new revised proposed amendment is different to the initial proposed amendment and it will be interesting to consult the revised explanatory memorandum to be issued in due course in order to gauge the rationale for the new proposal.

Jerome Brink

CDH
CLIFFE DEKKER HOFMEYR

Customs & Excise Highlights

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

Herewith below selected highlights in the Customs & Excise environment since our last instalment.

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

1. *Glencore Operations SA (Pty) Limited v The Commissioner for the South African Revenue Service*, case number 11696/18 in the High Court of South Africa, Gauteng Division, Pretoria:

   The judgment, delivered on 24 October 2019, has regard to eligibility of refund claims in relation to diesel used for primary production activities, specifically in mining, in terms of rebate item 670.04 in Schedule 6 to the Act. It states (*inter alia*) as follows:

   "... the crux of the dispute relates to whether the applicant used the diesel fuel in the manner intended in note 6(f) of Schedule 6 ...

   .....

   ... the activities in note 6(f)(iii) are non-exhaustive activities forming part of, i.e. included in, 'own primary production activities in mining'. It further follows that where activities conducted by the applicant do not fit exactly within any of the activities referred to in note 6(f)(iii) of the Schedule, but are in reality part and parcel of the kind of operations which the legislature intended to include in the concept of primary activities in mining, the non-exhaustiveness of list in note 6(f)(iii) of the Schedule permits that such activities are also subject to the concession relating to rebates of distillate diesel fuel. Thus, those activities qualify as primary production activities in mining as defined in note 6(f)(iii) of Schedule 6 part 3 of the Act".

   The Court interpreted note 6(f) to have a wider meaning and it is hoped that activities traditionally not accepted by SARS as eligible, will now be eligible allowing diesel refunds for such activities to be claimable.

   At the time of drafting this newsflash, it was uncertain whether the judgment will be appealed by SARS.

Amendments to Schedules to the Customs & Excise Act 91 of 1964 (Act) (certain sections quoted from the SARS website):

1. Schedule 1 Part 1:

   1.1 The substitution of tariff subheadings 1701.12, 1701.13, 1701.14, 1701.91, and 1701.99, to increase the rate of customs duty on sugar from 401.79c/kg to 476.61c/kg in terms of the existing variable tariff formula; and

   1.2 The substitution of tariff subheadings 1001.91 and 1001.99 as well as 1101.00.10, 1101.00.20, 1101.00.30 and 1101.00.90 to increase the rate of customs duty on wheat and wheaten flour from 66.47c/kg and 99.71c/kg to 100.86c/kg and 151.29c/kg respectively, in terms of the existing variable tariff formula.

2. Schedule 4:

   2.1 The insertion of rebate items 460.05/2712.10.20/01.08, 460.07/3916.90.90/01.08, 460.15/72.17/01.04, 460.16/8544.70/01.06 and 460.18/9001.10/01.06 in order to provide for a rebate on certain input material used in the manufacture of optical fibre cables and optical ground wire cables.

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CLIFFE DEKKER HOFMEYR

Customs & Excise Highlights...*continued*

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Notices issued by the International Trade Administration Commission (ITAC)

1. ITAC has received the following applications concerning the Customs Tariff:

   1.1 Review of rebate item 316.01/8415.90/02.06 dated 18 October 2019:

   Air conditioning machines, having a rated cooling capacity exceeding 3 kW, incomplete or unassembled, for the manufacture of air conditioning machines identifiable for use in heavy vehicles as defined in Note 1 to rebate item 317.07.

   Enquiries: ITAC Ref: 16/2019. Ms. Lufuno Maliaga. Tel: 012 394 3835 or email:lmaliaga@itac.org.za.

   Representations should be made within four (4) weeks of the date of the notice.

2. ITAC proposed an export duty on ferrous and non-ferrous waste and scrap on 18 October 2019:

   The duty is aimed to provide more effective support to foundries and mini-mills engaged in the processing of Scrap Metal. The imposition of export duties on Scrap Metal is being considered to replace the existing price preference system.

   The specific export duties being considered on certain categories of Scrap Metal are as follows:

Scrap Metal Category	Specific duty (R/tonne)	Equivalent percentage due (*ad valorem*)
Ferrous (including stainless steel)	R1,000	20%
Aluminium	R3,000	15%
Red metals	R8,426	10%
Other	R1,000	20%

   Interested parties are invited to submit written comments to the following officials:

   Mr Dumisani Mbambo, e-mail: dmbambo@itac.org.za, Tel: (012) 394 3743; Ms Lufuno Maliaga, email: lmaliaga@itac.org.za, Tel: (012) 394 3835; Mr Njabulo Mahlalela, e-mail nmahlalela@itac.org.za, Tel: (012) 394 3784; Mr Pfarelo Phaswana, e-mail: pphaswana@itac.org.za, Tel: (012) 394 3628; and Mr Tshepiso Sejamoholo, e-mail: tsejamoholo@itac.org.za, Tel: (012) 394 1605.

   Written submissions must be received within four weeks of the date of the notice, which is on or before 15 November 2019.

Customs & Excise Highlights

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SARS notices

1. SARS gave notice in terms of Rule 276(1)(b) of the Rules of the National Assembly that the Minister of Finance intends to introduce the Tax Administration Laws Amendment Bill, 2019, in the National Assembly. The explanatory summary of the Bill was published in accordance with Rule 276(1)(c) of the Rules of the National Assembly on 28 October 2019. The Bill provides for the amendment of, *inter alia*, the Act so as to:

   1.1 Make technical corrections;

   1.2 Insert definitions;

   1.3 Extend a provision providing for information sharing and exclude certain information from the application of the prohibition on disclosure of information;

   1.4 Clarify that an invoice may be amended by the issuing of an amended invoice or by the issuing of a credit or debit note in circumstances where the amount reflected on the invoice is amended;

   1.5 Clarify that tariff determinations, amendments to tariff determinations or new tariff determinations apply to all identical goods entered by the same person, whether the goods were entered before or after the date on which the determination is issued;

   1.6 Exclude bulk removals between excise manufacturing warehouses of alcoholic beverages classified under any subheading of heading 22.04 or 22.05 of Part 1 of Schedule 1 from compulsory tariff determinations;

   1.7 Clarify that value determinations, amendments to value determinations or new value determinations apply to goods mentioned therein entered by the same person before or after the date on which the determination is issued;

   1.8 Limit the circumstances in relation to which applications for general refunds will be considered; and

   1.9 Extend the general rule-enabling provision to include matters relating to the making of advance payments in relation to the importation of goods.

Please advise if additional information is required.

Petr Erasmus

CLIFFE DEKKER HOFMEYR

OUR TEAM

For more information about our Tax & Exchange Control practice and services, please contact:

Emil Brincker
National Practice Head
Director
T +27 (0)11 562 1063
E emil.brincker@cdhlegal.com

Mark Linington
Private Equity Sector Head
Director
T +27 (0)11 562 1667
E mark.linington@cdhlegal.com

Gerhard Badenhorst
Director
T +27 (0)11 562 1870
E gerhard.badenhorst@cdhlegal.com

Petr Erasmus
Director
T +27 (0)11 562 1450
E petr.erasmus@cdhlegal.com

Dries Hoek
Director
T +27 (0)11 562 1425
E dries.hoek@cdhlegal.com

Heinrich Louw
Director
T +27 (0)11 562 1187
E heinrich.louw@cdhlegal.com

Ben Strauss
Director
T +27 (0)21 405 6063
E ben.strauss@cdhlegal.com

Jerome Brink
Senior Associate
T +27 (0)11 562 1484
E jerome.brink@cdhlegal.com

Varusha Moodaley
Senior Associate
T +27 (0)21 481 6392
E varusha.moodaley@cdhlegal.com

Louis Botha
Associate
T +27 (0)11 562 1408
E louis.botha@cdhlegal.com

Louise Kotze
Candidate Attorney
T +27 (0)11 562 1077
E louise.Kotze@cdhlegal.com

BBBEE STATUS: LEVEL ONE CONTRIBUTOR

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.

JOHANNESBURG
1 Protea Place, Sandton, Johannesburg, 2196. Private Bag X40, Benmore, 2010, South Africa. Dx 154 Randburg and Dx 42 Johannesburg.
T +27 (0)11 562 1000 F +27 (0)11 562 1111 E jhb@cdhlegal.com

CAPE TOWN
11 Buitengracht Street, Cape Town, 8001. PO Box 695, Cape Town, 8000, South Africa. Dx 5 Cape Town.
T +27 (0)21 481 6300 F +27 (0)21 481 6388 E ctn@cdhlegal.com

STELLENBOSCH
14 Louw Street, Stellenbosch Central, Stellenbosch, 7600.
T +27 (0)21 481 6400 E cdhstellenbosch@cdhlegal.com

CDH
CLIFFE DEKKER HOFMEYR