TAX COURT RESOLVES AGE-OLD PROBLEM

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INTRODUCTION

For as long as anyone can remember, a tension has existed between the rules relating to the valuation of closing stock or inventory for accounting purposes, under IFRS, and the rules relating to trading stock at the end of the year for tax purposes, under section 22 of the Income Tax Act, 1962 (the Act).

On 6 July 2017, the Port Elizabeth Tax Court handed down a judgment (Case No. 13539/13673) which, if it is not appealed by SARS, will constitute something of a landmark, in that it will remove this tension, and pave the way for a standardisation of the manner in which inventory and trading stock can be valued for IFRS and tax purposes, respectively.

WHERE DOES THE TENSION LIE?

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 cost 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 it related to the judgment, was defined in IAS2 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".

At first blush 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.

THE TAX COURT'S ANALYSIS

The court examined the history of the legislation and how trading stock came to be treated under the Act. It also looked at a number of dicta from a number of leading cases, particularly those of the Supreme Court of Appeal.

Then, after examining the scheme of section 22 of the Act, the court concluded that, while it sets out a clear guideline for the manner of the calculation of the cost price, it does not prescribe any method by which to estimate whether a diminution in value has occurred. It recognises that a diminution in value occurs by reason of damage, deterioration, change of fashion, decrease in the market value or any other reason satisfactory to the Commissioner. But it does not indicate how it should be determined if it has indeed occurred.

The court also referred to paragraph 28 of IAS2, which was the relevant accounting statement at the time, and quoted from it. It stated that the cost of inventories may not be recoverable if those inventories are damaged, if they have been wholly or partially obsolete, or if their selling prices have declined. The cost may also not be recoverable if the estimated cost of completion or the estimated cost to be incurred to make the sale have increased. The court observed that the specific factors enumerated in section 22 correlate with the factors mentioned in IAS2.

The court then concluded that, on a careful consideration of the arguments presented, "the NRV as set out in IAS2 is an appropriate method by which to determine the actual value of trading stock in the hands of the taxpayer at the end of the year of assessment. The NRV, determined in this manner must be compared to the cost price, computed in accordance with section 22(3) in order to determine whether a diminution in value has in fact occurred". The court went on to say as follows:

> "In all the circumstances, whereas section 22(1) is silent as to the manner of valuation of trading stock at the conclusion of a year of assessment in order to determine whether a diminution in value has occurred the adoption of the NRV as a method of the assessment of value provides a sensible, business-like result which accords, in my view, with the purpose of section 22(1) in the context of the Act and with the weight of authority".

CONCLUSION

The practical result is that the tension referred to above has now been removed. Going forward, there ought to be no difference between the determination of the NRV under IFRS and the value of trading stock under section 22 of the Act, because the calculation of the NRV ought to give rise to the same value as the so-called stock provision for tax purposes.

It is unknown at this stage whether SARS has appealed the judgment.

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