Preamble

In this Note unless the context indicates otherwise –

- “paragraph (jA)” means paragraph (jA) of the definition of “gross income” in section 1(1);
- “paragraph (jA) asset” means an asset contemplated in paragraph (jA);
- “section” means a section of the Act;
- “the Act” means the Income Tax Act No. 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

1. Purpose

This Note provides guidance on the application and interpretation of paragraph (jA) and its interaction with other provisions of the Act.

2. Background

Taxpayers sometimes manufacture capital assets for use in their businesses which are similar to the trading stock which they manufacture for resale. The treatment of the amount received or accrued on disposal of such manufactured capital assets was the subject of a dispute between SARS and the taxpayer in C: SARS v Volkswagen of South Africa (Pty) Ltd. The taxpayer in that case manufactured motor vehicles for sale to the public but also manufactured vehicles for its own use which it used for some time and then sold. SARS argued that the proceeds on disposal of the latter vehicles was of a revenue nature. However, the court disagreed, holding that the amount derived from the disposal of these vehicles was of a capital nature.

As a result of the decision in the Volkswagen case paragraph (jA) was inserted into the definition of “gross income” in section 1(1). The effect of this deemed inclusion in gross income means that despite the amounts derived from the disposal of such assets being of a capital nature, they are deemed to be gross income and the assets remain trading stock until disposed of.

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1 2001 (2) SA 42 (SCA), 63 SATC 109.
2 Paragraph (jA) was inserted by section 17(1)(c) of the Second Revenue Laws Amendment Act No. 60 of 2001. It was amended by section 7(1)(f) of the Taxation Laws Amendment Act No. 24 of 2011 with effect from 1 April 2012.
3. **The law**

The relevant sections of the Act are reproduced in the **Annexure**.

4. **Application of the law**

4.1 **Paragraph (jA)**

Paragraph (jA) came into operation on 12 December 2001. It includes in the gross income of any person any amount received by or accrued to that person in respect of the disposal of any asset manufactured, produced, constructed or assembled by that person, which is similar to any other asset manufactured, produced, constructed or assembled by that person for purposes of manufacture, sale or exchange by that person or on that person’s behalf.

The effect of this provision is that amounts received or accrued from the disposal of paragraph (jA) assets will be included in the gross income of the taxpayer, even if those assets are used as capital assets.

The range of activities covered by paragraph (jA) is the same as the activities covered by paragraph (a)(i) of the definition of trading stock in section 1(1) with the following exception: Paragraph (jA) does not refer to anything “purchased or in any other manner acquired by a taxpayer”. Thus a person that acquires assets by purchase purely for the purposes of resale and subsequently uses some of those assets as capital assets will not fall within paragraph (jA). If such assets were acquired as capital assets at the outset any expenditure incurred on their acquisition will be of a capital nature from the outset. On the other hand if the assets were initially acquired as trading stock and subsequently used as capital assets, then the taxpayer must include the market value of the assets in income under section 22(8)(b)(v) while the base cost of the assets will be equal to the amount so included in income under paragraph 12(3) of the Eighth Schedule.

Not all assets that are purchased will, however, fall outside paragraph (jA). Whether a purchased asset falls outside paragraph (jA) will depend on the facts and circumstances of the particular case. For example, a second-hand asset purchased, which is similar to other assets manufactured, produced, constructed or assembled by the taxpayer, may fall within the ambit of paragraph (jA) if it is refurbished to such an extent that it no longer resembles, or has a utility substantially different from, the asset originally acquired as a result of undergoing a process of manufacture, production, construction or assembly.

4.2 **Definition of trading stock in section 1(1) [paragraph (a)(ii)]**

Paragraph (a)(ii) of the definition of “trading stock” in section 1(1) includes anything the proceeds from the disposal of which forms or will form part of the taxpayer’s gross income. It follows that paragraph (jA) assets comprise trading stock irrespective of whether they have been applied for purposes other than disposal in the ordinary course of trade.

4.3 **Recoupment of expenditure [paragraph (i) of the proviso to section 8(4)(a)]**

Paragraph (i) of the proviso to section 8(4)(a) excludes from recoupment under section 8(4)(a) any amount included in gross income under paragraph (jA). This exclusion ensures that when the assets are sold, the amount received or accrued on disposal is subject to tax only once.
4.4 Trading stock applied for a purpose other than disposal in the ordinary course of trade [paragraph (d) of the proviso to section 22(8)(b)(iv)]

Section 22(8)(b)(iv) provides for a market value inclusion in income when trading stock has been applied for a purpose other than disposal in the ordinary course of trade. Through a process of elimination it is evident that section 22(8)(b)(iv) was intended to cover, for example, trading stock which is –

- consumed by the taxpayer for the purposes of trade; or
- used by the taxpayer as a capital asset when the asset is a paragraph (jA) asset.

Paragraph (d) of the proviso to section 22(8) prevents an inclusion in income under section 22(8)(b)(iv) when a paragraph (jA) asset is applied as a capital asset.

**Note:** While a conversion of trading stock to a capital asset is normally dealt with under section 22(8)(b)(v) (asset which ceases to be held as trading stock) this provision cannot apply to a paragraph (jA) asset since such an asset remains trading stock until it is disposed of. This outcome follows from paragraph (a)(ii) of the definition of “trading stock” which includes in trading stock “anything the proceeds from the disposal of which forms or will form part of the taxpayer’s gross income”. Since the proceeds on disposal of a paragraph (jA) asset will always be included in gross income it will remain trading stock despite any change in usage.

In order to prevent any double taxation, any inclusion in income will therefore only be accounted for under paragraph (jA) when the asset is ultimately disposed of and not under section 22(8).

See Interpretation Note No. 65 (Issue 2) dated 5 February 2014 “Trading Stock – Inclusion in Income when Applied, Distributed or Disposed of Otherwise than in the Ordinary Course of Trade” for a discussion on section 22(8).

**Example – Trading stock applied for a purpose other than for disposal in the ordinary course of trade**

**Facts:**

A company imports computer parts and assembles them into desktop computers which it sells. The parts and assembled computers comprise trading stock.

Some of the computers assembled by the company are used by its sales personnel for demonstration purposes. These computers are used as capital assets and not for disposal in the ordinary course of trade. After two years the demonstration computers are sold to the company’s employees at their then prevailing market values.

**Result:**

The demonstration computers comprise trading stock under paragraph (a)(iii) of the definition of “trading stock” in section 1(1) because any proceeds on their disposal will form part of the company’s gross income under paragraph (jA).
Upon application of the demonstration computers as capital assets

Section 22(8)(b)(iv) deems the market value of the computers to be included in the company’s income when they are applied as capital assets. However, paragraph (d) of the proviso to section 22(8) prevents this deemed inclusion for paragraph (jA) assets.

Under the definition of “trading stock” the demonstration computers remain trading stock despite their deployment as capital assets. Therefore there will also be no deemed inclusion in the company’s income under section 22(8)(b)(v) (assets held as trading stock which cease to be held as trading stock).

Upon sale of the demonstration computers to employees

Any amounts received by or accrued to the company from the disposal of its demonstration computers to its employees on or after 12 December 2001 are included in its gross income under paragraph (jA).

It follows that the company must include the market value of the demonstration computers in its gross income under paragraph (jA) only when they are ultimately disposed of to its employees and not when they are applied as capital assets.

4.5 Interaction between paragraph (jA) and section 22

4.5.1 Closing stock [section 22(1)]

Under section 22(1) a taxpayer must include in closing stock the amount of any paragraph (jA) assets held and not disposed of at the end of the year of assessment because such assets comprise trading stock as defined in section 1(1).

Section 22(1) details the method by which trading stock must be valued at the end of the year of assessment for the purpose of determining the taxable income of the taxpayer. The basis of valuation generally will be cost less the amount by which the value of such stock has been diminished by reason of damage, deterioration, change in fashion, decrease in the market value or for any other reason satisfactory to the Commissioner. In this regard a decrease in the market value of the assets as a result of their use in the taxpayer’s trade will be a satisfactory reason to reduce their value under section 22(1). In this way the trading stock will be valued at the lower of cost or net realisable value.

4.5.2 Disposal at less than market value [section 22(8)(b)(ii)]

Assets that are disposed of otherwise than in the ordinary course of trade and for less than their market value, will result in the market value of the amount being included in the taxpayer’s income. When assets contemplated in paragraph (jA) are sold for less than their market value, the actual consideration will be subject to tax under paragraph (jA) of the definition of “gross income” while the difference between market value and the actual consideration will be included in the income of the taxpayer under section 22(8)(b)(ii).
4.6 Deductions

4.6.1 Cost of manufacture [sections 11, 22 and 23(g)]

A deduction for the expenditure incurred in manufacturing a paragraph (jA) asset must be considered under section 11(a) read with section 23(g). Its cost would normally be capitalised for tax and accounting purposes because it constitutes expenditure incurred with the intention of creating a capital asset. However, since the amount received or accrued on disposal of such an asset constitutes gross income and the asset constitutes trading stock, it will be accepted that the cost, determined on the same basis as for other similar trading stock items, allocated to the asset concerned will not constitute expenditure of a capital nature for purposes of section 11(a). This treatment is subject to the condition that the general requirements of the relevant sections have been met and that the transactions would not constitute an impermissible tax avoidance arrangement under section 80A to 80L.

The manufacturing costs of paragraph (jA) assets manufactured and disposed of –

- in the same year of assessment, will be deductible in full under section 11(a); and
- in different years of assessment, will be subject to section 22.

Having regard to the purpose of the legislation and taking the provisions of the Act as a whole into account it is clear that once an asset has been classified as trading stock it will be regarded as being intrinsically of a revenue nature and will fall within the confines of section 11(a) and section 22. It follows that since sections 11(a) and 22 are applicable to paragraph (jA) assets, no allowance may be claimed under other sections for example section 11(e) (wear-and-tear or depreciation allowance), 11(o) (allowance on alienation, loss or destruction of an asset), or 12C (the 40/20/20/20 allowance).

5 Conclusion

Any amount received by or accrued to a taxpayer from the disposal of a paragraph (jA) asset used as a capital asset on or after 12 December 2001 must be included in the taxpayer’s gross income. This inclusion in gross income means that a paragraph (jA) asset constitutes trading stock as defined in section 1(1) and section 22 will therefore apply.

In order to avoid double taxation, amounts included in paragraph (jA) are specifically excluded from inclusion in income under section 8(4)(a) and 22(8)(b)(iv).

The deductibility of costs associated with paragraph (jA) assets will be considered under section 11(a) read with section 23(g). No capital allowances can therefore be claimed for these assets

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Annexure – The law

Section 1(1) – Definition of “gross income” [Paragraph (jA)]

**(jA)** any amount received by or accrued to any person during the year of assessment in respect of the disposal of any asset manufactured, produced, constructed or assembled by that person, which is similar to any other asset manufactured, produced, constructed or assembled by that person for purposes of manufacture, sale or exchange by that person or on that person’s behalf;

Section 1(1)– Definition of “trading stock”

“trading stock”—

**(a)** includes—

(i) anything produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by the taxpayer or on behalf of the taxpayer;

(ii) anything the proceeds from the disposal of which forms or will form part of the taxpayer’s gross income, otherwise than—

**(aa)** in terms of paragraph (j) or (m) of the definition of “gross income”;

**(bb)** in terms of paragraph 14(1) of the First Schedule; or

**(cc)** as a recovery or recoupment contemplated in section 8(4) which is included in gross income in terms of paragraph (n) of the definition of “gross income”; or

Section 8(4)(a) – Paragraph (i) of the proviso

**(4) (a)** There shall be included in the taxpayer’s income all amounts allowed to be deducted or set off under the provisions of sections 11 to 20, inclusive, section 24D, section 24F, section 24G, section 24I, section 24J, section 27(2)(b) and section 37B(2) of this Act, except section 11(k), (p) and (q), section 12(2) or section 12(2) as applied by section 12(3), section 12A(3), section 13(5), or section 13(5) as applied by section 13(8), or section 13bis(7), section 15(a) or section 15A, or under the corresponding provisions of any previous Income Tax Act, whether in the current or any previous year of assessment which have been recovered or recouped during the current year of assessment: Provided that the provisions of this paragraph shall not apply in respect of any such amount so recovered or recouped which has been—

(i) included in the gross income of such taxpayer in terms of paragraph (jA) of the definition of “gross income”; . . .
Section 22(1) – Closing stock

22. Amounts to be taken into account in respect of values of trading stocks.—(1) The amount which shall, in the determination of the taxable income derived by any person during any year of assessment from carrying on any trade (other than farming), be taken into account in respect of the value of any trading stock held and not disposed of by him at the end of such year of assessment, shall be—

(a) in the case of trading stock other than trading stock contemplated in paragraph (b), the cost price to such person of such 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, not being any financial instrument, 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; and

Section 22(8)(b)(ii) – Disposal at less than market value

(8) If during any year of assessment—

(a) any taxpayer has applied trading stock to his private or domestic use or consumption; or

(b) any—

(i) taxpayer has applied trading stock for the purpose of making any donation thereof;

(ii) taxpayer has disposed of trading stock, other than in the ordinary course of his trade, for a consideration less than the market value thereof;

(iii) trading stock of any company has on or after 21 June 1993 been distributed in specie to any holder of shares in that company;

(iv) taxpayer has applied any trading stock for any other purpose other than the disposal thereof in the ordinary course of his trade and under circumstances other than those contemplated in paragraph (a) or subparagraph (i), (ii) or (iii) of this paragraph; or

(v) assets which were held as trading stock by any taxpayer cease to be held as trading stock by such taxpayer,

Section 22(8) – paragraph (d) of the proviso

and such amount shall be included in the income of the taxpayer for the year of assessment during which such trading stock was so applied, disposed of, distributed or ceased to be held as trading stock: Provided that where—

... 

(d) such trading stock consists of assets in respect of which any amount received or accrued from the disposal thereof is or will be included in the gross income of the taxpayer in terms of paragraph (jA) of the definition of “gross income”, the provisions of paragraph (b)(iv) shall not apply.