THE SUPREME COURT OF APPEAL OF SOUTH AFRICA

JUDGMENT

Reportable

Case no: 834/2018

In the matter between:

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE **APPELLANT**

and

ATLAS COPCO SOUTH AFRICA (PTY) LTD **RESPONDENT**

Neutral citation: *CSARS v Atlas Copco South Africa (Pty) Ltd* (834/2018) [2019] ZASCA 124 (27 September 2019)

Bench: Navsa, Ponnan, Zondi and Mocumie JJA and Weiner AJA

Heard: 28 August 2019

Delivered: 27 September 2019

Summary: Income tax – valuation of stock at year end in terms of s 22(1)(*a*) of the Income Tax Act 58 of 1962.

ORDER

On appeal from: Tax Court, Johannesburg (Opperman J and assessors):

(a) The appeal is upheld with costs, including those of two counsel.

(b) The order of the Tax Court is set aside and replaced with one dismissing the appeal and confirming the additional assessments for the 2008 and 2009 years of assessment.

JUDGMENT

Ponnan JA (Navsa, Zondi and Mocumie JJA and Weiner AJA concurring):

[1] The Income Tax Act 58 of 1962 (the Act) requires opening and closing trading stock to be taken into account when determining taxable income derived from carrying on any trade in any year of assessment. Section 22(1) of the Act is concerned with the value of trading stock held and not disposed of at the end of the relevant year of assessment, which is determined with reference to the diminution thereof. Sections 22(1)(*a*) and (*b*) of the Act prescribe the basis upon which taxpayers are to value trading stock at the beginning and end of each year of assessment. This appeal by the Commissioner for the South African Revenue Service (SARS), against a judgment of the Tax Court, Johannesburg (Opperman J, sitting with assessors), turns on the interpretation and application of those provisions. The dispute relates to whether the value of the taxpayer's

trading stock had diminished, entitling SARS to make a just and reasonable allowance under s 22(1)*(a)* of the Act.

[2] The taxpayer, Atlas Copco SA (Pty) Ltd, is a member of the Atlas Copco Group, with its parent company in Sweden. The main business of the taxpayer is to sell or lease – and thereafter service – machinery and equipment (including spare parts and consumables) that is 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.

[3] The taxpayer applied the policy by writing down its closing stock by the fixed percentages reflected in the policy. It included in its 2008 and 2009 tax returns 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 s 22(1)*(a)* of the Act. SARS accordingly added back R30 191 000 for 2008 and R33 402 000 for 2009 and assessed the taxpayer to tax in respect of those amounts on the ground that 'there was no diminishing in value at year end for a deduction to be claimed as a result of damage, deterioration, change of fashion, decrease in the market value in respect of stock'. SARS also levied interest in terms of s 89*quat* of the Act.

[4] In upholding the taxpayer's appeal and setting aside SARS' additional assessments for the 2008 and 2009 tax years, the Tax Court identified what it described as 'the crisp legal dispute between the parties' as being:

'whether the nett realisable value (*'NRV'*) of the Atlas Copco SA's closing stock, calculated in accordance with IAS2, IFRS, South African Statements of Generally Accepted Accounting Practice (*'SA GAAP'*) and the policy, 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 Income Tax Act.'

[5] The Tax Court answered that question thus:

'[128] The NRV of Atlas Copco SA's closing stock for 2008 and 2009, calculated in accordance with IAS2, IFRS, SA GAAP and the policy (which policy is 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 Income Tax Act.

[129] The NRV as determined in accordance with IAS2, IFRS and SA GAAP and the policy, provides an acceptable and appropriate method for purposes of section 22(1)(a) for the determination of the actual value of trading stock at the end of the year of assessment, the application of which leads to a sensible and business-like result. It constitutes a just and reasonable basis for valuing SA Copco SA's closing stock for 2008 and 2009, as contemplated in such section.'

[6] During the tax years relevant to this appeal, s 22(1)(*a*) provided:

'(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 SARS 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 SARS.'

[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'.[1] The section is couched in the past tense.

---

[1] Per Marais JA in *Richards Bay Iron and Titanium (Pty) Ltd & another v Commissioner for Inland Revenue* 1996 (1) SA 311 (A). He went on to explain at 316F-7C: 'The South African system of taxation of income entails determining what the taxpayer's gross income was, subtracting from it any income which is exempt from tax, subtracting from the resultant income any deductions allowed by the Act, and thereby arriving at the taxable income. It is on the latter income that tax is levied. The concepts involved are defined in the Act. *Commissioner for Inland Revenue v Nemojim (Pty) Ltd* 1983 (4) SA 935 (A) at 946G-H. Where a taxpayer is carrying on a trade, any expenditure incurred by him in the acquisition of trading stock is deductible in terms of s 11(*a*) of the Act because it is expenditure incurred in the production of income, and it is not of a capital nature. Income generated by the sale of such stock is of course part of the trader's gross income. Where in his first year of trading a trader has bought, and thereafter sold, all the stock which he acquired during that year, no problem arises. There will be a perfect correlation between the trading income earned and the expenditure incurred in that particular year in purchasing and selling the stocks sold, and the difference between the two sums will give a true picture of the result of the year's trading. There will be no stock on hand at the close of the year of which account need be taken. Contrast with that situation a situation in which the trader, having sold all the stock acquired earlier during that year at a substantial profit, purchases large quantities of stock just prior to the close of his tax and trading year. If he were permitted to deduct the cost of purchasing that stock from the income generated by his sales, without acknowledging the benefit of the stock acquired, he would be escaping taxation in that year on income which otherwise would have been taxable by the simple expedient of converting it into trading stock of the same value. That

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.

[8] The thrust of the taxpayer's case, which found favour with the Tax Court, was that the reference to market value in s 22(1)*(a)* of the Act is the same as the term 'net realisable value' (NRV)[2] as employed in the Statement of Generally Accepted Accounting Practice (AC 108) or International Accounting Standard 2 (IAS 2).[3] The Tax Court took the view that:

'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. It provides a sensible and businesslike result which accords with the purpose of section 22(1) being that the cost deduction deferred should be limited to what the taxpayer can reasonably expect to recover as at the end of the relevant tax year.'

---

process could be repeated every year *ad infinitum*. It is true that there would ultimately have to be a day of reckoning when trading finally ceases, but the fact remains that the taxpayer will have been enabled to avoid liability for tax until that point is reached. Where the trader is an individual who is subject to rising marginal tax rates as his trading profit increases, he would be enabled to so regulate his apparent profit that he immunised himself from them indefinitely.'

[2] NRV is defined in IAS2 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.

[3] In *Commissioner for the South African Revenue Services v Volkswagen South Africa (Pty) Ltd* [2018] ZASCA 116; [2018] 4 All SA 289 (SCA); 2019 (2) SA 362 (SCA) (*CSARS v Volkswagen*) para 28, Wallis JA explained: 'The International Financial Report Standards (IFRS) are internationally accepted standards issued by the International Accounting Standards Board (IASB). International Accounting Standard 2 (IAS 2) was originally issued in 1993 with revisions being issued in 2003 and 2006. The version with which we are concerned was updated on 2 January 2008. The Accounting Practices Board reissued it in South Africa as AC 108 without alteration and it forms part of the statement of Generally Accepted Accounting Practice (GAAP)'.

The Tax Court sought support for its approach in *Volkswagen South Africa (Pty) Ltd v Commissioner for South African Revenue Service*.[4] In that matter, Eksteen J found for the taxpayer, in the main, on the reasoning that:

'The nett realisable value (NRV) as determined in accordance with IAS2 provides an appropriate method by which to determine the actual value of trading stock in the hands of the respondent at the end of the years of assessment for the purposes of section 22(1) of the . . . Act.'

[9] SARS successfully appealed the judgment of Eksteen J. On appeal, this court in *Commissioner for the South African Revenue Services v Volkswagen South Africa (Pty) Ltd (CSARS v Volkswagen)* (per Wallis JA) held that Eksteen J had 'erred in failing to recognise that s 22(1)*(a)* is not concerned with contrasting cost price with the value determined by "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"'. It concluded:

'In looking for a sensible and business-like manner of valuation of trading stock at year end [Eksteen J] answered a question other than the one posed by the facts and formulated by the parties in the stated case. That question was whether NRV should be used to determine the value of trading stock at year end for the purposes of claiming an allowance against cost price under section 22(1)*(a)*. Whether it was a sensible and business-like manner of valuing trading stock from an accounting perspective was neither here nor there. The concern was whether it accurately reflected the diminution in value of trading stock contemplated in the section.'[5]

The correct position, so this court stated, is that:

'SARS may only grant a just and reasonable allowance in respect of a diminution in value of trading stock under section 22(1)(a), in two circumstances. The first is where some event has

[4] *Volkswagen South Africa (Pty) Ltd v Commissioner for South African Revenue Service* 80 SATC 58 (PE).
[5] *CSARS v Volkswagen* fn 3 above para 54.

occurred in the tax year in question causing the value of the trading stock to diminish. The second is 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. . . . Both scenarios are consistent with the basic proposition that the assessment of income tax relates to events that have already occurred rather than events that may occur in the future.'[6]

[10] Wallis JA commenced his judgment in *CSARS v Volkswagen*, with an interpretation of s 22(1)*(a)* of the Act and provided examples of what is contemplated by those provisions. He regarded the cost price as the 'baseline against which any diminution in value of the goods must be measured'[7] and concluded that on a proper interpretation of the section 'the cost price of the goods, and not the actual or anticipated value on their sale, is the benchmark against which any claimed diminution in value is to be measured'.[8] In the course of his judgment, Wallis JA passed the following important observations:

(a) Whilst annual financial statements prepared in accordance with a group's accounting handbook serve a valuable purpose in providing a true picture about the financial affairs of the company,[9] they are not necessarily equally applicable to the determination of liability to tax under the Act.

(b) Whilst there is obvious scope for an overlap between the provisions of s 22(1)*(a)* and those of IAS2, not all of the elements to which the latter refers relate to the same matters as the section.

---

[6] Ibid para 18.
[7] Ibid para 22.
[8] Ibid para 26.
[9] Ibid para 31.

(c) The determination of NRV is firmly based on an assessment of future market conditions.[10] The use of NRV is thus inconsistent with two basic principles that underpin the Act. The first is that taxable income is determined and taxation levied from year to year on the basis of events during each tax year. By contrast, NRV is explicitly forward looking. The second is that using NRV has the effect that expenses incurred in a future tax year in the production of income accruing to or received by the taxpayer in that future tax year, become deductible in a prior year.[11]

(d) The Act's provisions do not necessarily accord with current accounting principles. Thus, whether NRV reflects a diminution of value of trading stock for the purposes of s 22(1)(*a*) depends, not on its acceptance as part of GAAP, but on its conformity to the requirements for such a diminution in value as determined on a proper interpretation of that section.[12]

(e) While understandable from an accounting point of view, from a taxation perspective there were problems with taxpayer's approach. The fiscus is concerned with the value of trading stock as a whole.[13] For tax purposes the question is whether the taxpayer's trading stock as a whole had suffered a diminution in value.[14]

[10] Ibid para 36.
[11] Ibid paras 52 and 53.
[12] Ibid para 32.
[13] Ibid para 46. Wallis JA explained: 'Writing down the value of part of the stock to NRV ignores the fact that the NRV of the remaining stock is higher than cost price. The overall position with a company that is a going concern will probably be that the NRV of the trading stock, taken as a whole, will be greater than cost price. In a solvent and profitable trading company it would be surprising if it were not. Companies do not usually acquire, or manufacture, trading stock that they think will realise less than it cost. To pursue that course for any length of time would lead to insolvency. Using NRV is a legitimate approach from an accounting perspective. However, I can see no reason for the Commissioner to accept that Volkswagen's trading stock had diminished in value on the basis of a calculation where Volkswagen took advantage of the 'swings', where the NRV was lower than cost price, but disregarded the 'roundabouts', where the reverse was true.'
[14] Ibid para 46.

[11] It follows that, like Eksteen J in the *Volkswagen* matter, the Tax Court in this matter, also erred. I accordingly turn to consider whether on the principles laid down by this court in *CSARS v Volkswagen*, the trading stock of the taxpayer, which comprised six categories, namely: (i) slow-moving stock; (ii) overstock; (iii) demostock; (iv) Dynapac stock; (v) standard cost items and (vi) goods in transit, suffered a diminution in value.

[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.

[13] In that regard, Mr Jan Smit, the taxpayer's business controller, who was responsible for ensuring that the group's policies were implemented, testified:

'Mr Chohan: . . . And that's why I put to you, Mr Smit, that on the information conveyed to the Commissioner, Atlas's stance is we don't look at anything else. If it falls under a category, by virtue of its ageing, it is classified as such and it is then written off accordingly, either by 50% or 100%. And that's the method that was applied in 2008 and 2009. Yes?

Mr Smit: M'Lady, yes, I agree to that. It's because that is the method that has been identified which makes it, I could say, the most logical for us to be able to analyse the level of items that we have to do. I can't recall that there's any other recommendation from the Commissioner as to what method we should apply. We just need to get to an assessment, but how do you get to it, so this is the method that we've used.

Mr Chohan: Right.

Mr Smit: Which we believe is the most reasonable.'

That, as it turns out, is simply a time-based approach, which is not entirely consonant with the requirements of s 22(1)*(a)* of the Act.

[14] In the light of the approach to NRV by this court in *CSARS v* Volkswagen, the evidence of Mr Towlson, who led the taxpayer's external audit team, was by and large irrelevant, because the audit did little more than apply the taxpayer's group policy and the NRV in accordance with IAS2. In that regard, Ms Towlson's testified:

'Mr Chohan: Yes. And I'm putting this in very loose terminology Ms Towlson but you're more than welcome to correct me. You look at it, you say '[F]AM says if you're got stock for 12 months that has not moved, I'm going to write it off by 50%', you do a control test to see roughly speaking have they complied with that policy by looking at their inventory and see whether stock has not moved for that 12 months period, where [there] had been slight differences, you make a note of that. But by and large you have accepted on your analysis that over the 12 month period the inventory reflects correctly stock that had not moved.

Ms Towlson: Yes, so we're happy based on the aging that the provision had been fine in terms of that.

Mr Chohan: Yes. And then the next test of course you've got to determine is whether or not the write off has been correctly applied. So in other words the 50% as applied to those stock that was there for 12 months and 100% in relation to that stock that was there for 24 months.

Ms Towlson: Correct.

Mr Chohan: You don't test and nor were those your instructions, to test whether the stock that had been there for 12 months or 24 months should be written off at a lesser percentage or a higher percentage.

Ms Towlson: No, that wasn't part of our audit, that would have been looked at by the Group audit team . . .

Mr Chohan: Correct. Whatever procedures they undertook, that you are unaware of.

Ms Towlson: I'm unable to testify what they did specifically.

Mr Chohan: And you accepted as I understood, coming in as KPMG SA this is the policy, I'm told that this is the policy that they have to [apply] and I now test to see whether they've applied it.

Ms Towlson: Yes, and they implied that it was in terms of IFRS.'

It follows, despite the Tax Court's acceptance of Ms Towlson's evidence, that her evidence did little to advance the taxpayer's case. If anything, Ms Towlson's evidence serves to fortify the view that the taxpayer's employment of a fixed and rigid company policy was arbitrary and did not present the most reliable evidence available at the time in respect of any diminution in value.

[15] Moreover, although fleeting references were made to market value, as the following exchange between counsel for SARS and Mr Smit makes plain, no proper explanation or evidence was proffered, other than reliance on the group policy and the application of NRV:

'Mr Chohan: I'm heartened by that, Mr Smit, because when I look at each of these items . . . you will notice that the one thing that is missing, in relation to all of these examples, is the actual price at which the item was sold. . . . And may I offer you an explanation for why that information was not provided? It was not provided, because it wasn't considered by Atlas in determining whether or not the value of its stock, held in 2008 or 2009, had diminished. And the reason for that is because Atlas applied strictly the Way Forward Policy. If it fell in a bucket, 50% write-off, that's 12 months, and 24 months, 100%. Yes?

Mr Smit: M'Lady, if that's the interpretation of the Commissioner, from that side, from our side, we, you know, we apply a method. Because if we look at, we have about 20000 items actively, any day in time, to go and to try and to do that specific verification item by item, with the relevant pricing confirmations, will be a gigantic and an impossible task to do.

Mr Chohan: So, the answer to my question is yes, Atlas did not take into account the price at which it had sold stock during that year? It relied on a method, in terms of which it had applied a 50% write-off, if it fell into a 12 month bucket, and a 100% write-off if it fell in a 24 months bucket?

Mr Smit: I can, M'Lady, I can agree to the process we followed. So, basically, what we also do is we do monthly, a profitability analysis, where we first look at which items have we sold in a period of time below cost. Because those items is the first items we have to address and to see whether it is, if the pricing is market related or not, and why are we selling it below cost. Because those items would then be from a valuation perspective, over value.

. . .

Mr Smit: The next step is then, we then turn to the, this ageing bucket, ageing process, which is calculated, because that's, at the moment, looking at the number of items we have to deal with, it's the only method that we can currently apply in assisting us to identify items that potentially could have a reduction in their nett realisable value.

Mr Chohan: So, the starting point, you say, and this is, I must say, quite a revelation, is to assess the price at which the items were sold at below cost price, in order to determine reasons, market fluctuations, etcetera. Where do I find any evidence of that, Mr Smit? Would there be minutes of those meetings?

Mr Smit: M'Lady, there won't be minutes for it, but what we used to do is, we had Excel spreadsheets, which was an extract from our sale statistics, and it was then monthly sent to the relevant business Line Managers to say, please, let's look at all the negative gross profit developments.

. . .

Mr Chohan: Has that been provided to the Commissioner by Atlas?

Mr Smit: Looking at all this, no.'

[16] Significantly, during the audit, Ms Towlson and her team also identified products that had been sold below cost in order to determine whether they should be written down and by what percentage. In this regard, she only identified three product lines that had been sold below cost and on average those products were sold at approximately 24 to 26% less than their cost. The true factual position is thus a far cry from the application of a fixed 50 or 100% write off in terms of the group policy. This historical evidence ought to have featured in the determination of whether or not there was any diminution in value of the trading stock as contemplated by s 22(1) of the Act. But it did not. Instead, the taxpayer chose the application of a fixed percentage based policy grounded on an aging analysis. What is more, Ms Towlson's audit team recorded that the taxpayer's group policy was 'a very aggressive policy' and for that reason, the risk of inventories being carried at more than their NRV was deemed low 'considering the aggressive write down policy'.

[17] It must follow from what has thus far been stated that the taxpayer's approach to the valuation of its trading stock is flawed. That, ordinarily at any rate, ought to be dispositive of the appeal against it. However, in the light of the objections raised, explanations proffered and the circumstances giving rise to the appeal, it is necessary to turn to a consideration of each of the six categories that made up the taxpayer's closing

stock. Given the overlap in evidence, it will be convenient to consider the slow-moving and overstock categories together. The taxpayer asserted that inasmuch as it operated within the mining sector and had to meet orders at relatively short notice, it was necessary to keep larger volumes of stock to hand than would otherwise have been the case. Whilst it may be difficult to quarrel with that as a general theoretical proposition, the taxpayer oftentimes had difficulty explaining the sheer volume of stock to hand or the treatment of such stock for tax purposes. In that regard the evidence ran:

'Mr Chohan: Mr Smit, I'm not contesting your need to keep stock or to buy stock to appease your customers. I'm contesting the treatment of that stock as overstock, simply because in 12 months you bought two items, your sold one, the other one you didn't sell, and Atlas now regards it as an overstock item, which it writes down by 50%. That's what I'm challenging.

Mr Smit: M'lady, in that perspective it's correct, but that one that's left in stock now, is not to say that we will be able to sell it, because for 12 months we were only able to sell one. So, who's to tell or what's to tell that we will be able to sell the other one as well.

Mr Chohan: And who's to [tell], so you won't be able to sell it?

Mr Smit: Exactly. It is an estimate.

Mr Chohan: Ja. Atlas, it seems, as I understand your evidence, prides itself on efficiency, that was your opening comments yesterday when you gave evidence. One would think, given the drive for efficiency, you would have some sort of historical data indicating what items should be bought and at what levels they should be bought in order to maintain that efficiency. Yes?

Mr Smit: Yes.

. . .

Mr Chohan: I'd like to take the pneumatic drill as an example . . .

You had sales of 18 rock drills over a 12 month period, but you had kept 388 items in stock. So, Atlas, obviously bought too many of these.

Mr Smit: M'Lady, what I wanted to say on the, previously, was that we do have systems that assist us programmatically, or automatically to review stocking levels of items. So, in the background these are systems with logic that does review the consumption and then make proposals as to what we should keep in future in stock. We also have the opportunity to manually intervene in those system decisions, based on market information that we get from our sales people, where they are negotiating future contracts with customers, with the potential of securing that business. So, those adjustments to the logics, obviously then, governs what the level should be. But the, we not always 100% secure of that business, that a contract will materialise. So, it could be that there's suddenly a change in market demand, changes from customers, that they change their mind, they go to a competitor, or alternative suppliers. And then we sit with the unfortunate situation where we have overstock.

Mr Chohan: My logic tells me that that logic was wrong in relation to this particular item, because, obviously, you have far too many items held in stock for that period. Whether it was due to market conditions, people going to competitors, etcetera, that's the result. Is that not so?

Mr Smith: M'Lady, that is the result, yes. But we need to also on this item actually go and fundamentally understand the detailed background of it, why did we end up in this situation, was it a system error from an employee in our company, or was there a contract that was cancelled by a customer, that effected this result.

Mr Chohan: Right. And you can't tell us exactly what the reasons are for it at the moment, as you sit here today?

Mr Smit: Yes, I can't tell it for each and every item, no.

Mr Chohen: And the Commissioner doesn't know whether this is an error, or whether there's some reason behind it, etcetera. All it is given is this document on which it must make an assessment?

Mr Smit: Yes'

The taxpayer thus appears to have taken no account of any diminution in value in respect of such stock. Its approach simply was: because we had not sold all of the items, who is to know whether we will be able to sell what remains of the stock. The write off was thus at best an unmotivated guesstimate.

[18] The third category, described by the taxpayer as 'goods in transit', were goods for whatever reason that had to be returned to the taxpayer's parent company in Sweden. Mr Smit testified:

'Court: . . . is there a Way Policy applicable to how these goods are treated?

Mr Smit: M'Lady, the only I can recall, there is a write up on, in our Way Policy about goods in transit, how it should be treated, but it does not specifically say what the specific amounts is that you need to account for, because that is on a case by case basis, as we agreed with the supplying counter Atlas Copco company, as to what it's going to be. Because there's various things they need to take into account. There could be items that we want to return that is no longer in production, or there's no longer any demand in the market for it. Even if it's not in South Africa, maybe even in other countries there's not a demand for it, so the product company will not take it back, because if they do take it back, they will have to, on their end, make a valuation assessment whether they should scrap it or not, if they can't then supply it to another Atlas Copco company. So, there, it's a whole evaluation process we have to undergo with them. And then only they'll say you are now allowed to return this list of items, with these quantities, and then it's also still subjected to a final inspection process, from a quality perspective, as to what we are returning to them.

Assessor: How do you val[u]e them? At the original cost or at the agreed value, or, you know, in this provision?

Mr Smit: M'Lady, in this provision, the amount that's in the provision is an estimate, what we said, shortfall, which we will expect where the product supplying company will deduct an amount for the administration fee for returning it to them. So, that's really just for he handling administration fee is the portion that we provide for.'

Once again, the taxpayer relied on an unsubstantiated estimate. Ms Towlson's evidence did not help matters. According to her:

'Mr Chohan: Let me see, I'm not sure you answered my question, so let me put it to you again. What audit work did you do in relation to testing whether the adjustment by Atlas for goods in transit was correct or not, or did you – in other words did you have regard to those credit notes? Did you have regard to an actual adjustment having been made or did you accept management's explanation that they get normally a 20% adjustment on goods that are sent back to Sweden?

. . .

Ms Towlson: Okay, so the note we've written here is that the CTO land cost factor can be anywhere between 10 and 32%. That would have been based on . . . .

Mr Chohan: On an explanation.

Ms Towlson: No.

Mr Chohan: Or on a document?

Ms Towlson: On the work that we would have done. So we would have independently said that we would expect it to be 10 to 32% and therefore we would expect, the credit expected would be generally between 70 and 80% so we would have expected a larger percentage. And then because the percentage was lower, we then obtained explanations. So in this instance they were returned – they were left on the dock, they suffered rust damage and therefore they only expected to receive a credit of 20%.

. . .

Mr Chohan: So based on the explanations that were given by management regarding the particular inventory that had been sent back, you then made provision, or at least evaluated it and you were happy that the adjustment was correctly made.

Ms Towlson: So we were happy that there was a 70 to 80% (indistinct) the 20 yes.'

[19] Importantly, even though the group policy did not apply to the demostock, Dynapac stock and standard cost items, the taxpayer dealt with them no differently to the first three categories. Insofar as the demostock, which was supplied to the taxpayer's customers on consignment, was concerned, the process that should have been followed by the taxpayer was to identify items and value them in order to determine any diminution thereof. Instead, it simply wrote down the value of such stock by 50% as though the group policy applied. What is more, some of the demostock was written off by 100% based on the external auditor's inability to find such stock. This, in circumstances where Mr Smit was unable to say which stock this related to, or why the auditors had made such a note in their working papers. If the demostock was purchased by the taxpayer's customers, well and good. If not, according to Mr Smit:

'Court: And then the third category is the demonstration items. Is that correct? And there's no Way Policy for how that's calculated?

Mr Smit: No, M'Lady, the demo stock is, it was, we classified it as demo, and we kept it as part of an inventory, but in reality we should have actually taken it out of inventory, and put it in a, like in a fixed asset register, where you have normal depreciation, as deprecation on it as the customers would be using it. But from an administrative process, we kept it as part of the inventory, but segregated on, in a unique warehouse. So, it was then not part of this ageing reporting, so that we can still keep traceability on these items and know where it is, and where it are, and then do valuations on them as, at point in time.

Assessor: That valuation is at 50% of cost, or was there a difference in some categories.

Mr Smit: M'Lady, on the demo stock, if you go and look at the calculation, I think on those it was all 50%, taken across all items at the time, at the end of December 2008.

. . .

Mr Chohan: Right. So, let me just see if I understand that correctly. The Auditors, having conducted their audit, say to you that in relation to demo stock, we have found that this stock has been . . . on consignment. It is located either at customers or, in some instances, at various warehouses. I assume Atlas's warehouses?

. . .

Mr Smit: Yes.

Mr Chohan: We know from what you've said earlier on that instead of valuing it a 50% provision was made for slow moving items of these demo stock, but then there are those demo stock which, presumably, your system has picked up exists as part of your inventory, but which you cannot locate or find, or which the Auditors couldn't locate or find?

Mr Smit: The items, they are shown in inventory in a specific warehouse, or warehouses.

Mr Chohan: Right.

Mr Smit: Which doesn't form part of any of the ageing reports, because it's a unique classification. So, but we know which items is demo and where is it, in which warehouses, and the warehouses normally reflects the location where it is.

Mr Chohan: Okay. What I'm enquiring, Mr Smit, is the Auditors comment that a 100% provision was created for demo stock that could not be located, or was missing. So, if the demo stock is kept in a warehouse, and you know it's kept separately from other items, you have a system, it seems a very sophisticated system, that keeps track of all your stock, demo stock, separately. This is stock that the Auditors were unable to locate for one or other reason, in the warehouse.

Mr Smit: M'Lady, I don't know what, at that stage, what the Auditor, his interpretation was on this. Whether there was specific items that they were looking for, which they could not find, and whether it was based on the feedback that we gave them to say if we, because what we do is with those different warehouses, if the people that's at the warehouse tells us the item is no longer there, because the system shows you should have it, then we will write it off and scrap it, because it's missing. So, this could, I'm not, I don't know what the interpretation of the . . . .

Mr Chohan: You don't know, despite the . . . [c]onversations that you may have had with the Auditors, you don't know what this means?

Mr Smit: I don't know what his interpretation was on this, yes.

Mr Chohen: And you, therefore, don't know why the 100% provision was created for such stock . . .

Mr Smit: It could have been a comment that he made based on our discussions as to how we handle the transaction.

Mr Chohan: I don't want you to speculate, Mr Smit, I want you to see if you can't assist me on what you know, as a matter of fact.

Mr Smit: Can you maybe just repeat again, what do I need to know.

Mr Chohan: Yes. You are unable to assist the Commissioner or the Tax Court as to what demo stock the Auditor is referring to, and why the provision of 100% was made in relation to that.

Mr Smit: M'Lady, the only thing I have on the demo side is a listing of the items which we have provided, which makes up the full list. Those are the only items I can account for that forms part of the provision.'

[20] Turning to the Dynapac stock: The evidence was that Dynapac was acquired by the taxpayer during October 2008. Unlike the taxpayer, which was involved in the mining sector, Dynapac was involved in the supply of heavy duty equipment for road construction. The taxpayer included Dynapac's stock in its closing stock, which it valued on the basis of the provision allegedly made for such items by Dynapac. In that regard Mr Smit testified:

‘Mr Chohan: . . . So, you acquired Dynapac’s trading stock, and that would have included its heavy machinery, capital equipment and spare parts. In determining the value of that trading stock that Atlas had acquired, Atlas had simply adopted the provisions that had been made by the seller . . .

Mr Smit: Yes.

Mr Chohan: You, as Atlas, at the time conducted no independent assessment of the value of that trading stock.

Mr Smit: M’Lady, normally how the acquisition process works is we getting our due diligence processes early in the construction of the deal, we look at what the potential seller is using in how they come to a definition of their cost of their trading stock. Are they applying average costs, are they applying standard costing, actual costing.

. . .

Mr Chohan: So, let me come back to my question, just to make it absolutely certain. As you sit here today, you do not know how that provision had been calculated?

Mr Smit: M’Lady, I don’t know how it was calculated, only that it was based on the historical information out of the seller’s financial system, also based on an ageing analysis methodology.

Mr Chohan: . . . are you able to tell us today what ageing process was applied by the seller and what percentage write-offs were applied by the seller?

Mr Smit: M’Lady, I can’t say right now, but if I go and look at the data that we have related to Dynapac in 2008, I can most probably then do an analysis on it, but I can’t say right now. No, I can’t answer that.

. . .

Mr Chohan: Now, I understood your evidence to say that, because Dynapac stock had been only acquired in October 2008, it was treated differently, because there was no historical data on which you could rely, for purposes of implementing the Way Policy?

Mr Smit: M’Lady, yes, it was, we could only take it based on how the seller has done it.

Mr Chohan: . . . You'll see that Ms Simpson says,

'Please could you arrange to have the following . . . stock scrapped. These items have 100% provision against them as per 24 slow moving.'.

Can you assist me in relation to that, Mr Smit? I can only assume that she is not, referring to Atlas Copco's policies, because it could never have been slow moving in terms of that policy, having only been acquired in October 2008.

Mr Smit: M'Lady, yes, it would not, could not have been part of the Atlas Copco one, because we had a separate Excel listing of the items that we acquired from Dynapac.

Mr Chohan: So, must I assume, when I read this e-mail . . . . That she is, in fact, referring to the seller's provisions?

. . .

Mr Smit: Yes. And, M'Lady, the reason for it also was, is if we look at the timing, and the amount of items involved, we acquired them in October 2008, so, and then we had, basically, two and a half months available to conclude the whole acquisition transaction, because that was also the year end for our annual financial year end. So, we were under enormous pressure in the organisation to bring them into our business, so we did not have the, honestly, the opportunity to do a proper valuation.'

The approach by the taxpayer to the Dynapac stock was similarly based on an aging methodology, the basis of which the taxpayer did not know or did not bother to ascertain. It simply adopted the provision that had been made by Dynapac for such stock.

[21] The taxpayer's treatment of standard cost items also suffers from a lack of adherence to s 22(1) of the Act. This category comprises stock that the taxpayer had purchased from its parent company, only to be notified by the latter later during the tax year of a price increase or decrease. That resulted in a corresponding price adjustment

and had a knock-on effect on the value of the stock held at year end (referred to as a standard cost item in the taxpayer's accounts). But, the taxpayer was simply unable to tender any satisfactory evidence on that score. And, what is more, as the following excerpt illustrates, Mr Smit also had difficulty identifying which items the apparent cost increase or decrease applied to.

'Mr Chohan: And in order to determine whether or not there had been in 2008 or 2009, any such change, one would expect a notification or document, or some sort of a memorandum from the parent company, or the supplying company, informing Atlas Copco of this price update.

Mr Smit: M'Lady, I think in our Group we work, not necessarily, on a notification like that, we work with transit pricing agreements, which is, transit pricing agreements, internationally been agreed between all the different parties, how we handle pricing.

. . .

Mr Chohan: So, one would have some or other documentary evidence, either electronically or if you printed it out physically, of that price change happening in January of each year, or some time shortly thereafter?

Mr Smit: Yes, there will be some communication . . .

. . .

Mr Chohan: And that would be, and based on those documents, Atlas Copco would then, invariably, adjust its pricing for the stock that is held by it, either upwards or downwards, depending on the update.

Mr Smit: Yes, it gets initiated in our system to reflect the new pricings.

Mr Chohan: So, in order for the Commissioner to assess whether or not that had, in fact, occurred, rather than simply just a statement that says I reduce this, because of what is described as standard cost change items, one would expect to see that notification, I put it, conveyed electronically in January of each year.

Mr Smit: Yes, there will be, there is some communications.

Mr Chohan: We do not have that as we sit here today. You can't point to the document?

Mr Smit: Ja, I can't point the Commissioner to something.

Mr Chohan: And as Atlas's witness, you can't tell me, in relation to which items the updates applied and in what respect?

Mr Smit: If we talk about 2008, I can't, not right now, no.

Mr Chohan: And, of course, in 2009, in fairness to you, you weren't there, so you can't comment on it.

Mr Smit: Yes.'

[22] It is apparent when the evidence relating to all six categories 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 were 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.

[23] It follows for all the reasons given that the judgment of the Tax Court cannot stand. In my view, it cannot be said that SARS failed to exercise the discretion conferred by s 22(1)*(a)* reasonably and properly. Insofar as the imposition of section 89*quat*(2) interest

is concerned, no warrant exists for a remittal in terms of s89*quat*(3) of the Act. The appeal must accordingly succeed.

[24] In the result:

(a) The appeal is upheld with costs, including those of two counsel.

(b) The order of the Tax Court is set aside and replaced with one dismissing the appeal and confirming the additional assessments for the 2008 and 2009 years of assessment.

V M Ponnan
Judge of Appeal

APPEARANCES:

For Appellant:	M Chohan SC (with him R Tsele)
	Instructed by: MMMG Attorneys, Rivonia Phatshoane Henney Attorneys, Bloemfontein
For Respondent:	J Boltar (with her M van Kerckhoven)
	Instructed by: Bowmans, Sandton McIntyre van der Post, Bloemfontein