SOUTH AFRICAN REVENUE SERVICE

# INTERPRETATION NOTE NO. 11

DATE: 25 March 2003

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| **ACT** | **:** | **INCOME TAX ACT, 1962 ("the Act")** |
| **SECTION** | **:** | **SECTIONS 1 and 22** |
| **SUBJECT** | **:** | **TRADING STOCK: ASSETS NOT USED AS TRADING STOCK** |



## 1. Background

Paragraph (jA) was inserted into the definition of "gross income" in section 1 of the Act in terms of section 17(1)(c) of the Second Revenue Laws Amendment Act, No 60 of 2001. This amendment has the effect that certain assets that could under certain circumstances be regarded as capital assets are now included in the definition of trading stock for purposes of calculating taxable income.

The purpose of this interpretation note is to clarify the interpretation and application of the new legislation and its interaction with other provisions of the Act, some of which have been amended as a consequence of the insertion of paragraph (jA).

## 2. The law and its application

### 2.1. <u>The definition of gross income</u>

Paragraph (jA) of the definition of "gross income" in section 1 came into operation on 12 December 2001 and applies to the disposal of any asset manufactured, produced, constructed or assembled by the taxpayer, which is similar to any other asset manufactured, produced, constructed or assembled by the taxpayer for purposes of manufacture, resale or exchange (hereinafter referred to as **"paragraph (jA) assets"**) on or after 12 December 2001. The effect of this provision is that the gross receipts in respect of such assets will constitute gross income once the assets are disposed of by the taxpayer or by someone on behalf of the taxpayer.

Example

A company imports computer parts and assembles such parts in order to sell desk top computers to the market. The parts and completed computers constitute trading stock. The company imported certain parts annually with the specific intention of using them in the building of computers for the sales personnel. After a period of two years the computers are sold to the personnel at their then market value. The computers are, therefore, specifically designated for use by the company as capital assets and not for disposal in the ordinary course of trade. The proceeds from the disposal of any computers, assembled for the use of personnel, disposed of on or after 12 December 2001 will constitute "gross income" in the same manner as would all the other computers assembled for resale.

2.2. The definition of trading stock

In terms of paragraph (a)(ii) of the definition of "trading stock" in section 1 of the Act any asset –

"*the proceeds from the disposal of which forms or will form part of his gross income, otherwise than in terms of paragraph (j) or (m) of the definition of 'gross income', or as a recovery or recoupment contemplated in section 8(4) which is included in gross income in terms of paragraph (n) of that definition;*"

is regarded as trading stock for purposes of section 22 of the Act. The proceeds of any paragraph (jA) assets are now specifically included in the gross income of a taxpayer. It follows, therefore, that paragraph (jA) assets are now regarded as trading stock irrespective of the fact that they have been applied for purposes other than disposal in the ordinary course of the taxpayer's trade. In addition, these assets will remain trading stock despite the fact that they were originally manufactured, produced, constructed or assembled with the intention to be used as capital assets.

2.3. Recoupment of expenditure

The provisions of section 8(4)(a) of the Act have also been specifically amended to exclude any amount included in gross income by virtue of the provisions of paragraph (jA). This exclusion is to ensure that upon the sale of these assets the amount is not subjected to income tax more than once, i.e. as a result of the specific inclusion in “gross income” and the taxation of any recoupment of depreciation allowances previously allowed.

2.4. Cost of manufacturing

The deductibility of the cost attributable to paragraph (jA) assets will be considered in terms of section 11(a) and 23 of the Act. The normal rules such as whether a trade has been conducted, the expenditure has been incurred in the production of income, etc will be applied.

The cost of these assets would normally have been capitalised for tax and accounting purposes as it constituted expenditure incurred with the intention of creating capital assets. In view of the fact that the proceeds from the disposal of these assets will now constitute “gross income”, it will be accepted that the cost (determined on the same basis as for the other similar trading stock) to be allocated to the paragraph (jA) assets will not constitute expenditure of a capital nature for purposes of section 11(a) of the Act. This view is subject to the condition that the general requirements of the relevant sections have been met and that the transactions would not constitute a transaction, scheme or arrangement as envisaged in terms of section 103 of the Act.

The manufacturing costs of paragraph (jA) assets will, therefore, be deductible in full if the production and the disposal thereof take place during the same year of assessment. If on the other hand, production and disposal of paragraph (jA) assets do not take place during the same year of assessment, the deduction will be subject to the provisions of section 22.

Due to the fact that the provisions of sections 11(a) and 22 are applicable to paragraph (jA) assets no allowance may be claimed in terms of sections 11(e), 11(o), 12C, etc. of the Act.

2.5. <u>Stock on hand</u>

(a) Closing Stock

In the case where “paragraph (jA) assets” are held and not disposed of by the taxpayer at the end of the year of assessment, the provisions contained in section 22(1) will be applicable.

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, for example, the use thereof in the taxpayer’s trade will be a satisfactory reason to reduce the value in terms of section 22(1). (In other words, such stock will be valued at the lower of cost or net realisable value.)

(b) Opening Stock

In terms of section 22(2)(a) the amount which must be taken into account in respect of the value of any trading stock at the beginning of the year of assessment is the amount which was taken into account in respect of the value of the trading stock at the end of the preceding year of assessment.

(c) Cost price of stock

Section 22(3) provides that the cost price of trading stock is –

- the cost incurred during the current or any previous year of assessment in acquiring the stock; plus
- any further costs incurred in getting the stock into its existing condition and location.

(d) Utilising trading stock for purposes other than the disposal in the ordinary course of trade

Section 22(8)(b)(iv) of the Act provides for the situation where trading stock has been applied for a purpose other than the disposal thereof in the ordinary course of trade, for example, the provision of assets to employees, and in such circumstances the cost price of such stock (which has been taken into account in the determination of taxable income), will be deemed to have been recovered or recouped at an amount equal to the market value of such stock. In terms of paragraph (d) of the proviso to section 22(8)(b) no adjustment to gross income needs to be made where paragraph (jA) assets are utilised in the trade of the taxpayer (other than the disposal in the ordinary course of trade).

(e) Disposal at less than market value

In the case where the assets are sold at a value less than their market value and the provisions of section 22(8)(b) are applicable, the amount that is to be included in the taxpayer's income remains the market value. The actual consideration will be subject to tax by virtue of paragraph (jA) of the definition of "gross income" and the difference between market value and the actual consideration must be included in the income of the taxpayer in terms of section 22(8)(b).



2.6. <u>The treatment of paragraph (jA) assets used as capital assets prior to 12 December 2001.</u>

The inclusion of the proceeds in gross income from the sale of paragraph (jA) assets is effective as from 12 December 2001. It is, therefore, possible that the assets were manufactured prior to this date and used for purposes other than the disposal thereof in the ordinary course of trade. Generally, an allowance in terms of sections 11(e) or 12C of the Act would have been claimed on the assets. These assets, however, constitute trading stock as from 12 December 2001. For purposes of section 22 these assets must be taken into account for purposes of calculating the value of trading stock as at the end of the first year of assessment ending on or after 12 December 2001.

In the case of assets that are held by a person otherwise than as trading stock and such assets commence to be held as trading stock, paragraph 12(1) of the Eighth Schedule to the Act deems the assets to have been disposed of at market value. The effect hereof is that a capital gain or loss must be determined on 12 December 2001 in respect of paragraph (jA) assets. In terms of section 22(2)(b) these assets must be taken into account as opening stock at their cost price. Section 22(3)(a)(ii), however, determines the cost of the assets in these circumstances to be equal to their market value.

**3. Conclusion**

All paragraph (jA) assets used as capital assets subsequent to 12 December 2001 must therefore be taken into account for income tax purposes. A deduction equal to the actual costs incurred will be allowed and their opening and closing values must be brought into account as provided for in section 22.

**Law Administration**
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