South African Revenue Service

DRAFT INTERPRETATION NOTE

DATE:

ACT	**:**	**INCOME TAX ACT 58 OF 1962**
SECTION	**:**	**SECTION 22(1)(*a*)**
SUBJECT	**:**	**DIMINUTION IN THE VALUE OF CLOSING STOCK**

Contents

Preamble

In this Note unless the context indicates otherwise –

- **"closing stock"** means trading stock held and not disposed of by the taxpayer at the end of a year of assessment as contemplated in section 22(1)(*a*);
- **"IAS"** means an International Accounting Standard;
- **"IFRS"** means the International Financial Reporting Standards issued by the International Accounting Standards Board;
- **"section"** means a section of the Act;
- **"the Act"** means the Income Tax Act 58 of 1962;
- **"the TA Act"** means the Tax Administration Act 28 of 2011;
- **"trading stock"** means trading stock as defined in section 1(1); and
- any other word or expression bears the meaning ascribed to it in the Act.

1. Purpose

This Note provides guidance on the determination of the diminution in the value of closing stock, which is deducted from the cost of that closing stock for purposes of determining the value of closing stock that must be included in gross income under section 22(1)(*a*).[1]

This Note does not deal with the valuation of trading stock in the case of mining companies, farmers or trading stock falling under section 22(1)(*b*).

This Note replaces Practice Note 36 "Income Tax: Valuation of Trading Stock" issued on 13 January 1995.

2. Background

Generally speaking, if the requirements of a relevant section are met, taxpayers are allowed to claim a deduction for expenditure and losses actually incurred during the year of assessment against their income received or accrued in that year. Taxpayers are generally allowed to claim a deduction under section 11(*a*) for the expenditure incurred in acquiring trading stock in the year of assessment in which the trading stock is acquired, as the expenditure would be incurred in the production of income and not of a capital nature. For example, if trading stock is purchased and sold during the same year of assessment, there would be an inclusion of the selling price in the taxpayer's gross income, and a deduction under section 11(*a)* for the expenditure incurred in purchasing the trading stock. If trading stock is not sold during the year of assessment in which it is purchased, there would be no inclusion in the taxpayer's gross income, but there would be a deduction under section 11(*a*) for the trading stock purchased. Section 22 addresses this timing mismatch by aligning the year in which a deduction is effectively given with the year in which there is an inclusion of the selling price in gross income. This is, broadly speaking, achieved by section 22(1)(*a*) that requires that the amount of closing stock must be added to gross income when determining taxable income, and section 22(2) that effectively allows a deduction for opening stock in the subsequent year of assessment.

Section 22(1)(*a*) also prescribes the basis on which the amount of closing stock must be determined. Specifying the basis tells taxpayers how the amount must be determined and in so doing also prevents possible manipulation that may arise by, for example, a taxpayer adopting a basis that gives a lower amount, therefore a lower gross income inclusion and a lower taxable income in the particular year of assessment.

3. The law

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

4. Interpretation and application of the law

4.1 Introduction

Section 22(1)(*a*) provides that the amount of closing stock is the cost price of the closing stock less such amount that the Commissioner may think just and reasonable as representing the amount by which the value of such closing stock, not being a financial instrument, has diminished by reason of damage, deterioration, change of

[1] Read with proviso (*i*).

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fashion, decrease in market value or any other reason satisfactory to the Commissioner. The amount of such diminution is subject to the discretion of the Commissioner, which is subject to objection and appeal.[2]

Financial instruments[3] are included at cost price, since they are specifically excluded from trading stock for which taxpayers are permitted to potentially take into account any diminution in the value of closing stock.

Under section 22(3),[4] the cost price of trading stock is described as the cost incurred by a taxpayer, whether in the current or any previous year of assessment, in acquiring the trading stock, including any further costs incurred by the taxpayer, in terms of IFRS in the case of a company, in getting the trading stock into its condition and location but excluding exchange differences relating to the acquisition of the trading stock. In addition, in determining the cost price of an item of trading stock it is not acceptable to use a basis that treats the last item of trading stock as the first item disposed of on or after the date of acquisition.[5]

In the context the words "amount … by which the value of such closing stock … has diminished" refers to the amount by which the cost price of the closing stock has diminished due to one of the specified reasons.[6]

Wallis JA in *C: SARS v Volkswagen South Africa (Pty) Ltd*[7] confirmed this interpretation:

> "The only way to make sense of the expression "value of such trading stock" in this context is to accept that it refers to an artificial concept of value represented initially by the cost price of the goods. That is the baseline against which any diminution in the value of the goods must be measured.
>
> …
>
> I conclude that on a proper interpretation of section 22(1)(*a*) the cost price of the goods, and not the actual or anticipated market value on their sale, is the benchmark against which any claimed diminution in value is to be measured."

In summary, the value of closing stock can therefore be represented as:

Amount of closing stock = cost price − amount of the diminution in value of closing stock

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[2] Section 3(4)(*b*) includes section 22(1).

[3] See definition in section 1(1).

[4] See section 22(3) and section 22(3A) for further detail.

[5] Section 22(5).

[6] That is, due to damage, deterioration, change in fashion, decrease in market value or any other reason satisfactory to the Commissioner.

[7] [2018] 4 ALL SA 289 (SCA); 81 SATC 24 at 36 and 37.

The diminution in the value of closing stock can be represented as follows:

Amount of the diminution in value of closing stock = cost price − value of closing stock • If the result is negative, there is no diminution in value. • If the result is positive, there has been a diminution but it will only be allowed if the diminution is due to one of the specified reasons.

The words "diminished", "damage", "deterioration" and the phrases "change in fashion" and "decrease in market value" are not defined in the Act. Therefore, these words and phrases must be interpreted according to their ordinary meaning as applied to the context and the subject matter with regard to which they are used.[8] See below for a consideration of these words and phrases.

4.1.1 Meaning of "diminish" and when the diminution must be determined

Section 22(1)(*a*) requires a taxpayer to include an amount in respect of closing stock at the end of the year of assessment in gross income. The amount of closing stock to be included in gross income is equal to cost price less the amount by which cost price has diminished (see **4.1**).

Section 22(1)(*a*) refers to "diminished" which is the past tense of the word "diminish".

Dictionary.Cambridge.org defines the words "diminish"[9] and "diminution",[10] respectively, as follows:

> "(v) to reduce or be reduced in size, importance or value:"
>
> "(n) a reduction in size, importance, or value:"

The *Merriam Webster* dictionary defines the word "diminish" as follows:[11]

> "[2] to make smaller in amount, volume, or extent:
>
> Synonyms for *diminish*: abate, de-escalate, decrease, dent, deplete, downscale, downsize, drop, dwindle, ease, knock down, lessen, lower, reduce."

Whether the cost price of the closing stock has diminished due to one of the specified reasons, has to be determined at the end of the year of assessment based on the facts of the specific case (see **5.2** for the timing of the events that can be taken into account in determining the diminution).

If the same item of trading stock is still on hand at the end of a succeeding year of assessment, whether the cost price of that item has diminished is determined based on the facts applicable at the end of that succeeding year of assessment. For example, new events may have occurred that caused the amount of the diminution in the value

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8 EA Kellaway *Principles of Legal Interpretation of Statutes, Contracts, and Wills* (1995) Butterworth's at 224. See also *C: SARS v Terraplas SA (Pty) Ltd* [2014] 3 All SA 11 (SCA), 76 SATC 377 at 385 and *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA) at 604.

9 **www.dictionary.cambridge.org/dictionary/english/diminish** [Accessed 2 October 2024].

10 **www.dictionary.cambridge.org/dictionary/english/diminution** [Accessed 2 October 2024].

11 **www.merriam-webster.com/thesaurus/diminish** [Accessed 2 October 2024].

of closing stock at the end of the succeeding year of assessment to increase or decrease, or it may have stayed the same.

Example 1 – Determining the diminution in trading stock in subsequent years of assessment

Facts:

Trading stock item A had a cost price of R500. At the end of year 1 it was still on hand and its market price was R400.

At the end of year 2 item A remained unsold and its market price increased to R550. Item A was sold during year 3 for R550.

Result:

Year 1

Section 22(1)(*a*) requires a taxpayer to include an amount in respect of closing stock at the end of the year of assessment in gross income. The amount of closing stock to be included in gross income is equal to cost price less the amount by which cost price has diminished by reason of damage, deterioration, change of fashion, decrease in market value or for any other reason satisfactory to the Commissioner.

Diminution = Cost of R500 − Value of R400 = R100

Closing stock = Cost price of R500 − R100 (diminution) = R400

Year 2

Item A remained unsold at the end of year 2, therefore under section 22(1)(*a*) an amount in respect of closing stock at the end of the year of assessment must be included in gross income.

Diminution = Cost of R500 − Value of R550 = -R50 (negative so no diminution)

Closing stock = Cost price of R500 − Rnil (diminution) = R500

Note: This effectively means that, through the mechanism of opening stock (a deduction of R400) and closing stock (an inclusion in gross income of R500), the write down of R100 in year 1 will be reversed by a net inclusion of R100 (R500 − R400) in taxable income in year 2.

4.1.2 Meaning of "damage"

Dictionary.com defines the word "damage" as follows: [12]

> "[1] (n) injury or harm that reduces value or usefulness:"

Actual damage to the trading stock from an action or event that causes it to have a loss in value or usefulness is required.

Damage to trading stock could be caused by natural elements (fire, water and wind), human intervention, a combination of both or other factors, for example, damage in transit. Damage may occur to an item, some of the items or a category of trading stock.

[12] **www.dictionary.com/browse/damage** [Accessed 2 October 2024].

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Further, as noted in **4.1**, the damage to the trading stock must diminish the value of that stock below the cost price recognised for that trading stock. A mere possibility that the trading stock could have been subject to damage at the end of the year of assessment is insufficient to write down its value at the end of the year of assessment. For example, Taxpayer A has 5 000 items of X on hand at the end of the year of assessment. Taxpayer A was aware that during the year a unit of X was damaged during a transfer between two stores and had to be sold at below cost. There is a risk that the units of X on hand at the end of the year of assessment may similarly have been damaged during transfers between stores. The risk and possibility of damage is in itself insufficient to support a conclusion that there has been a diminution in value of trading stock on hand at year-end.

The nature of the damage must be so severe when measured against the cost price that it can be said in common parlance "the goods are no longer worth that".[13] Goods only slightly damaged may still be profitably sold, that is, sold above cost, such that there is no diminution. Only reductions in value below the cost price of the trading stock would justify an exercise of the Commissioner's discretion,[14] and be taken into account in determining the value of closing stock.

The taxpayer bears the onus to prove[15] the damage as well as the extent of such damage, and the impact on its value. Each case will be determined having regard to the specific facts.

Example 2 – Valuation of closing stock

Facts:

Company A's year of assessment ends on 31 March.

Company A purchased the following trading stock on 15 March year 1:

a) Three units of Item A at a cost of R60 000 each.

b) Two units of Item B at a cost of R120 000 each.

Company A expected to sell the units of Item A for R80 000 each, and the units of Item B for R150 000 each in year 2.

During the year-end stock count on the 31 March year 1, the two units of Item B suffered extensive damage and as a result Company A will not be able to sell the units for more than R105 000 each.

Result:

Year 1:

	R
Gross Income – Closing Stock [section 22(1)(*a*) and proviso (i); see note 2]	390 000
Less: Cost of Trading Stock [section 11(*a*); see note 1]	(420 000)
Net	(30 000)

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13 *C:SARS v Volkswagen SA (Pty) Ltd* [2018] 4 ALL SA 289; 81 SATC 24 at 36.

14 *C:SARS v Volkswagen SA (Pty) Ltd* [2018] 4 ALL SA 289; 81 SATC 24 at 36.

15 Section 102 of the TA Act.

Through the combined operation of section 11(*a*) and section 22(1)(*a*), Company A effectively deducts the diminution below cost on the two units of Item B in year 1.

Note:

1) Cost of Trading Stock:

	R
Item A = 3 units × cost of R60 000 per unit	180 000
Item B = 2 units × cost of R120 000 per unit	240 000
	420 000

2) Closing stock = cost price − diminution in value of closing stock*

* Diminution in value = cost price − value of stock; if the result is negative there is no diminution in value, if it is positive then there has been a diminution but it will only be allowed if the diminution is due to one of the specified reasons.

Item A:

Diminution = Cost of R60 000 − value of R80 000 = -R20 000; negative so no diminution

Closing stock = 3 × (Cost price of R60 000 − Rnil diminution) = R180 000

Item B:

Diminution = Cost of R120 000 − value of R105 000 = R15 000; positive so there is a diminution in the value of closing stock the cause of which was the permitted reason of damage.

Closing stock = 2 × (Cost price of R120 000 − R15 000) = R210 000

Total value of closing stock = Item A + Item B = R180 000 + R210 000 = R390 000

4.1.3 Meaning of "deterioration"

Dictionary.com defines the words "deterioration" and "deteriorate", respectively, as follows: [16]

> "(n) 2. the state or condition of having deteriorated."
>
> "verb 1. to make or become worse or inferior in condition, character, quality, value etc."

Deterioration of trading stock can result in it becoming impaired or inferior in quality, functioning or condition. The taxpayer bears the onus to prove[17] that deterioration has occurred as well as the extent of such deterioration, and the impact on the trading stock's value.

For example, certain trading stock needs to be sold or consumed within an estimated time from the date of manufacture, production or packaging. This is due to the trading stock having a limited "life span" or "shelf life". Typically, this type of trading stock has

[16] **www.dictionary.com/browse/deterioration** and **www.dictionary.com/browse/deteriorate** [Accessed 2 October 2024].

[17] Section 102 of the TA Act.

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either or both a “sell by” and “best before” date on the packaging of the product. After a certain time period the trading stock becomes less effective or suitable for its intended purpose, and this will often impact on the value of the trading stock as it may only sell if the selling price is reduced. Another example is that a “sell by” date could have an influence on the decision by prospective purchasers on which product to purchase, with the result that the same or similar product with a later “sell by” date may be purchased instead of a product with an earlier “sell by” date. This could result in increased quantities of trading stock with shorter shelf-lives that are held and not disposed of at the end of the year of assessment and it may, but not necessarily, mean that a reduced price will be required in order to sell the items. There may therefore be a diminution in value. The condition of trading stock could also deteriorate whilst in transit or in storage. For example, a cargo of first grade rice undergoing heating at sea, such that it has to be downgraded to second or third grade, which trades at a value lower than first grade rice.[18]

Similar to “damage” (see **4.1.2**), the nature of the deterioration must be so severe when measured against the cost price that it can be said in common parlance “the goods are no longer worth that”.[19] Goods that have only slightly deteriorated may still be profitably sold, that is, sold above cost, such that there is no diminution. Only reductions in value below the cost price of the trading stock would justify an exercise of the Commissioner’s discretion[20] and be taken into account in determining the value of closing stock.

4.1.4 Change of fashion

Trading stock that is, for example, subject to constant technological innovation or seasonal fluctuations is likely, but not necessarily, to decrease in value.

Products subject to technological changes include, for example, computers and cell phones. The extent and speed of the decrease in value will depend on, amongst others, the degree and speed of technological innovation of new products, and the current demand for the existing product as supported by the most recent sales data. Clothing is an example of trading stock that may be subject to seasonal fluctuations. The value of seasonal clothing that is unsold at the end of the year of assessment will often, but not necessarily, suffer a decline in value. Although it is normally retained for sale in the following year of assessment, it may only sell at a lower price due to the lower demand for the prior year’s fashion trends.

The taxpayer bears the onus[21] to substantiate the decrease in value below cost due to a change in fashion by reference to, for example, the necessary documentary evidence at or close to the end of the year of assessment. As noted above, only reductions in value below the cost price of the trading stock will be taken into account when determining the value of closing stock at the end of the year of assessment.

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[18] *C:SARS v Volkswagen SA (Pty) Ltd* [2018] 4 ALL SA 289 ; 81 SATC 24 at 36.
[19] *C:SARS v Volkswagen SA (Pty) Ltd* [2018] 4 ALL SA 289 ; 81 SATC 24 at 36.
[20] *C:SARS v Volkswagen SA (Pty) Ltd* [2018] 4 ALL SA 289 ; 81 SATC 24 at paragraph 21.
[21] Section 102 of the TA Act.

4.1.5 Decrease in market value

Factors that could lead to a decrease in market value of an existing product include the following:

- A supply into the market of generic equivalents that are cheaper than the original product.
- An oversupply caused by a manufacturing overrun or a lack of demand owing to obsolete technology.
- A significant decrease in the exchange rate of the currency in which the trading stock was imported that results in the cost of currently imported trading stock being much lower and retailers passing on the savings to customers through a reduced selling price.

If, for example, one of the factors listed above, resulted in a taxpayer reducing the selling price of its trading stock, there would be a decrease in market value. However, only reductions in value below the cost price of the trading stock will be taken into account when determining the value of closing stock at the end of the year of assessment.

In *CIR v Atlas Copco South Africa (Pty) Ltd*[22] the taxpayer had written off slow moving and obsolete trading stock for accounting and tax purposes according to its group accounting policy of a 50% write-off if the trading stock had not sold in 12 months and 100% write-off if it had not sold in 24 months. The taxpayer's argument was essentially that "market value" equalled net realisable value (NRV) in terms of IAS 2 and, by implication, because their fixed time-based method was acceptable as NRV for accounting purposes, it was also acceptable for tax purposes. The group accounting policy percentages that were applied were not tested for appropriateness against evidence available at the time, for example, the actual price at which the items were sold. To the contrary, the taxpayer's auditors identified only three products that were sold at 24% to 26% below cost. The higher provisioning of 50% and 100% was, however, acceptable from an accounting NRV perspective as it meant there was a low probability that stock was being carried at above NRV. The court disagreed with the taxpayer's view that "market value" equalled NRV and found that SARS had exercised its discretion reasonably and properly in finding that the taxpayer's write-down did not comply with the requirements of section 22(1)(*a*) since "there was no diminishing in value at year end for a deduction to be claimed as a result of damage, deterioration, change of fashion or decrease in market value". In the Volkswagen case discussed in **4.1.6** of the Note, the taxpayer unsuccessfully tried to argue that a diminution reflected in NRV (determined on a different basis to Atlas Copco and arguably more in line with IAS 2), which was lower than cost constituted a diminution "for another reason satisfactory to the Commissioner".

The taxpayer bears the onus[23] to substantiate the decrease in market value by, for example, the reference to the necessary documentary evidence such as sales invoices at or close to the end of the year of assessment. As noted above, only reductions in value below the cost price of the trading stock will be taken into account when determining the value of closing stock at the end of the year of assessment.

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22 [2019] 4 All SA 635 (SCA), 82 SATC 116

23 Section 102 of the TA Act.

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Example 3: Diminution based on group accounting policy

Facts:

Taxpayer A is part of the MM Group that sells air fryers to the public. The group's accounting policy requires all subsidiary companies to provide a provision for diminution in the value of closing stock equal to 25% of the cost of all air fryers included in closing stock at the end of the financial year. The end of the financial year is the same as the end of the year of assessment.

At the end of the year of assessment Taxpayer A had three models of air fryers in closing stock, A1 (1 000 units at a cost of R1 000 per unit), A2 (1 200 units at a cost of R1 500 per unit) and A3 (500 units at a cost of R2 500 per unit).

Sales after year-end reflect a selling price for A1 of R1 500, A2 of R1 275 and A3 a selling price of R1 900.

Taking the group accounting policy into account, Taxpayer A raised a provision for financial reporting purposes equal to 25% of cost for the diminution in the value of closing stock held and not disposed of at the end of its year of assessment.

Result:

Section 22(1)(*a*) requires a taxpayer to include in gross income an amount in respect of closing stock at the end of the year of assessment. The amount of closing stock to be included in gross income is equal to cost price less the amount by which the cost price has diminished by reason of damage, deterioration, change of fashion, decrease in market value, or for any other reason satisfactory to the Commissioner.

The method adopted by Taxpayer A for accounting purposes of reducing the cost price of all items of closing stock by a fixed percentage of 25% may not be used by Taxpayer A when calculating the value of closing stock for income tax purposes. The accounting method does not comply with the requirements of section 22(1)(*a*) as any diminution must be determined on an item-by-item or an appropriate category of trading stock basis (see **5.1**) and "air fryers" as a whole is not an appropriate category given the different market profile for different types of air fryers. In addition, the method of a blanket 25% provision does not consider whether there has in fact been a diminution in value of the air fryers and the extent of such diminution by taking into consideration, for example, recent sales.

The diminution in the cost price of closing stock is determined as follows:

	Cost Price (R)	**Selling Price (R)**	**Diminution (per unit) (R)**
A1	1 000	1 500	0
A2	1 500	1 275	225
A3	2 500	1 900	600

The selling price of Item A1 is in excess of its cost price therefore there is no diminution and the amount for purposes of inclusion of closing stock in gross income under section 22(1)(*a*)(i) will be its cost price.

The selling price for Items A2 and A3 have decreased to below the cost price of the items therefore under section 22(1)(*a*) a diminution due to a decrease in the market value for the items has occurred. In determining the amount of closing stock to be included in gross income under section 22(1)(*a*)(i), the cost price per unit of Item A2 and A3 may be reduced by R225 and R600, respectively.

4.1.6 Other reasons satisfactory to the Commissioner

Section 22(1) contemplates the possibility of there being other reasons for a diminution of value apart from the four reasons specified in **4.1.2** to **4.1.5** above. For that reason it empowers the Commissioner to make a just and reasonable allowance to accommodate a diminution in value of trading stock for any other reason that may be satisfactory to the Commissioner. As noted above, only reductions in value below the cost price of the trading stock will be taken into account when determining the value of closing stock at the end of the year of assessment.

The taxpayer bears the onus to prove[24] that the decline in value was due to another reason which, in the context of section 22(1)(*a*), should be satisfactory to the Commissioner. Each case will be determined having regard to the specific facts.

In *C: SARS v Volkswagen South Africa (Pty) Ltd*[25] the taxpayer contended that there had been a reduction in the value of its closing stock "for another reason". The taxpayer contended that the net realisable value (NRV) of closing stock, as determined under IAS 2,[26] properly reflected the value of closing stock and therefore if NRV was below cost, there was a diminution in value of trading stock that was due to "any other reason satisfactory to the Commissioner" which should be recognised in determining the value of closing stock.

"Net realisable value" is defined in IAS 2 as –[27]

> "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".

The Court disagreed with the taxpayer and found that while there is scope for overlap[28] between section 22(1)(*a*) and IAS 2, there are elements in IAS 2 that are outside of the scope of section 22(1)(*a*). The net realisable value was therefore not an acceptable basis for determining the value of closing stock and the diminution of the NRV below cost did not therefore constitute "any other reason satisfactory to the Commissioner".

In the judgment Wallis JA found as follows:[29]

> "Whether the concept of NRV reflects a diminution of value of trading stock for the purposes of s 22(1)(a) depends therefore, not on its acceptance as part of GAAP [*Generally Accepted Accounting Practice]*, but on its conformity to the requirements for such a diminution in value as determined on a proper interpretation of that section."

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24 Section 102 of the TA Act.

25 [2018] 4 ALL SA 289 (SCA); 81 SATC 24.

26 IAS 2 prescribes the recognition, measurement and disclosure of inventories (trading stock) financial accounting purposes.

27 IAS 2 at paragraph 6.

28 For example, if, before year end, trading stock was damaged, wholly or partially obsolete or if selling prices has declined below cost, the diminution below cost due to one of these reasons would be recognised under IAS 2 and section 22(1)(*a*).

29 *C: SARS v Volkswagen South Africa (Pty) Ltd* [2018] 4 ALL SA 289 (SCA); 81 SATC 24 at 38.

After analysing IAS 2 and the determination of NRV, and in addition to identifying some practical difficulties, Wallis JA held that the use of NRV is inconsistent with two basic principles that underpin the Act and therefore section 22(1)(*a*). The first principle is that generally taxable income is determined and taxation levied from year-to-year on the basis of events that have taken place during the relevant tax year. In contrast to this "backward looking" approach, NRV is explicitly "forward looking". It is concerned with the amount that the trader is likely to receive when the goods are realised and therefore takes expenses that will still be incurred in making the sale into account. The second principle is that using NRV has the effect that expenses incurred in a future tax year become deductible in a year prior to being actually incurred which is contrary to one of the requirements in section 11(*a*) that the expenditure must be actually incurred.

Such other reasons could be taxpayer or trade specific. The reasons, which must be satisfactory to the Commissioner, will be assessed on a case-by-case basis.

5. Other

5.1 "Item-by-item" or "category" basis

In the *Volkswagen* case the Court noted that "(f)or tax purposes the question is thus whether trading stock as a whole had suffered a diminution in value" and that a taxpayer cannot take advantage of the "swings" when the value was lower than cost price but disregards the "roundabouts" when the reverse was true.[30]

This aspect of the judgment raised some concerns as before the above-mentioned judgment many taxpayers and SARS had practically considered whether there had been a diminution in the value of closing stock on an item-by-item or, where appropriate, a category basis and a diminution on one item of trading stock was not reduced by an unrealised increase in the value above cost on another item.

Subsequent to the *Volkswagen* case, the legislature introduced proviso (ii) into section 22(1)(*a*) which provides that –

> "(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…".

Proviso (ii) confirms that the recognition of a diminution in the value of any item of closing stock is not affected by an appreciation in the value of another item of closing stock. In calculating the value of closing stock, a taxpayer may therefore claim a reduction for the diminution in value below cost of a specific item of trading stock, or, if appropriate, a category of trading stock, for one of the specified reasons notwithstanding that other items of trading stock may have appreciated in value.

Whether it is appropriate to analyse closing stock on an item-by-item basis or a category basis and, if the latter, what constitutes appropriate categories, must be determined on the facts of the particular case. For example, if there are large volumes of the same small items of closing stock it is often appropriate to group those items into one category and to determine the value of the closing stock and the amount of the diminution below cost for the category using suitable sampling. However, there may be conditions that make grouping the same items into one category inappropriate. For example, if one had 1 000 units of a particular spare part on hand at the end of the year of assessment, 200 of which had been damaged during transportation before

30 *C:SARS v Volkswagen SA (Pty) Ltd* [2018] 4 ALL SA 289); 81 SATC 24 at 24.

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year-end and 800 of which were in pristine condition, it may be inappropriate to put all the units into one category if the damaged versus undamaged status has a significant impact on the value of the item and therefore a significant impact if one category had been used. In the case of large value items or unique items, it is often, but not necessarily, more appropriate to analyse each item on an item-by-item basis. Taxpayers must consider their specific circumstances when deciding whether is it reasonable and appropriate to analyse closing stock on an item-by-item basis or in categories (and if in categories, what categories) and must be able to support their decision with reference to their facts and supporting evidence.

5.2 Timing of the events that resulted in the diminution of value

In *C: SARS v Volkswagen South Africa (Pty) Ltd* the Supreme Court of Appeal noted the following:[31]

> "The taxpayer is required to determine the value of its trading stock at a particular point in time, namely, the end of the tax year. As is generally the case in determining the taxpayer's taxable income that is an exercise of looking back at what happened during the tax year in question. An important aspect of the language in section 22(1)(*a*) is that the allowance that the Commissioner may think just and reasonable is 'an amount by which the value of the trading stock has been diminished'. That language is couched in the past tense. The section is accordingly not concerned with what may happen to the trading stock in the future, but with an enquiry as to whether a diminution in its value has occurred at the end of the year of assessment. All the instances expressly referred to in the section, namely damage, deterioration, change of fashion and decrease in market value, relate to a diminution of value occurring prior to the taxpayer rendering its return as a result of events occurring prior to that date."

In *CIR v Atlas Copco South Africa (Pty) Ltd*[32] the Court took the same approach in holding as follows:

> "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 … circumstances specified … 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."

In the *Volkswagen* case the Supreme Court of Appeal went on to hold that, consistent with the proposition that the assessment of income tax relates to events that have already occurred rather than events that may occur in the future, SARS may only allow a just and reasonable allowance in respect of a diminution in the valuation of trading stock in two circumstances, namely –[33]

- an event, which caused the value of closing stock to diminish for one of the specified reasons, has occurred during the relevant tax year; or
- it is known with reasonable certainty that an event will occur in the following tax year that will cause the value of closing stock to diminish for one of the specified reasons.

[31] *C: SARS v Volkswagen South Africa (Pty) Ltd* [2018] 4 ALL SA 289; 81 SATC 24 at 34.
[32] [2019] 4 All SA 365 (SCA) at 635.
[33] *C: SARS v Volkswagen South Africa (Pty) Ltd* [2018] 4 ALL SA 289; 81 SATC 24 at 35 and 37.

Example 4 – Timing of event that resulted in the diminution of trading stock

Facts:

Taxpayer A sells furniture at a standard mark-up of 75%. Taxpayer A moved furniture from a warehouse to two of its retail stores. During the transfer, the furniture was physically damaged and as a result of the damage the furniture had to be sold at a discount of 50%.

Result:

If the trading stock was transported and damaged before the end of year 1, the event would have taken place during year 1 and the diminution in the value below cost would be taken into account in determining the value of any of the damaged trading stock still on hand at the end of year 1.

In contrast, if the trading stock was transported and damaged during year 2, at the end of year 1 the event is not one which had taken place during year 1 and it is not one which was known with reasonable certainty at the end of year 1. Therefore, the diminution in the value below cost would not be taken into account in determining the value of closing stock at the end of year 1.

The Supreme Court of Appeal provided the following example of an event that might constitute one that it is known with reasonable certainty will occur in the following tax year. [34]

> "... knowledge that a glut had built up in the market for a perishable commodity, where that glut would ensure a marked, certain and unavoidable decline in the price of that commodity."

As noted above, there will only be scope for an allowance if the events in question have led to the cost price of the goods ceasing to be a proper measure of their value. In substance, the allowance enables the taxpayer to say that, because of the diminution in value of its trading stock, it has suffered a loss in the current year and it should be permitted to set off that loss in the determination of its taxable income for the current year instead of waiting for it to materialise when the goods are sold in a later year.[35]

5.3 Disclosure required in respect of diminution in the value of closing stock

A taxpayer that values trading stock below cost price must disclose this fact to the Commissioner in the relevant tax return. The disclosure of the above information will assist the Commissioner in the exercise of the discretion contained in section 22(1)(*a*).

The value by which closing stock has diminished in section 22(1)(*a*) is subject to the discretion of the Commissioner. This discretion can be applied only if the Commissioner is made aware of the actual write-down. In ITC 1489 Conradie J held as follows:[36]

> "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 Revenue should be told how that percentage is arrived at.

34 *C: SARS v Volkswagen South Africa (Pty) Ltd* [2018] 4 ALL SA 289; 81 SATC 24 at 35.
35 *C: SARS v Volkswagen South Africa (Pty) Ltd* [2018] 4 ALL SA 289; 81 SATC 24 at 37.
36 (1990) 53 SATC 99 (C) at 104.

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> There is a good deal to be said for the view that the Act by implication requires such a disclosure. The Commissioner has to exercise a discretion with regard to the amount by which the value of trading stock has been diminished. He cannot exercise that discretion if he is not told on what basis the accounts submitted to him have been prepared."

In addition, when submitting the return, a taxpayer must provide, for example –

- details of the basis on which stock is valued;
- if applicable, reasons for valuing trading stock below cost and details regarding the methodology used in valuing the written-down stock; and
- if stock has been written off on a fixed, variable or any other basis, not representing the actual value by which closing stock has been diminished, reasonable justification for the basis applied.

SARS may request supporting evidence for the write down and the information provided in the return.

Trading stock that has been valued below cost may result in the imposition of understatement penalties under section 222 of the TA Act if it transpires that the value of closing stock has been understated.

A taxpayer bears the burden of proving that an amount or item is deductible or may be set-off;[37] or that a valuation is correct.[38]

6. Conclusion

Section 22(1)(*a*) is a balancing mechanism for the deduction claimed under section 11(*a*) for trading stock purchased during the year but still on hand at the end of the year of assessment. Closing stock held and not disposed of at the end of the year of assessment is included in gross income. The value of that closing stock is the cost price of the trading stock, less any amount that represents any diminution in value which the Commissioner may think just and reasonable by reason of damage, deterioration, change of fashion, decrease in market value or for any other reason satisfactory to the Commissioner. The value of such diminution is subject to the discretion of the Commissioner and subject to objection and appeal.

The diminution in the value of closing stock must be determined on an item-by-item basis or, if appropriate, on a category basis.

The judgment of the Supreme Court of Appeals in the *Volkswagen* and *Atlas Copco South Africa* cases may be referred to as authority on section 22(1) for the following principles:

- The cost price of the goods and not the actual or anticipated market value is the benchmark against which any claim for the diminution in value is to be measured.
- A claim for a diminution of cost price must be based on events that exist at the end of the year of assessment or events that it is known with reasonable certainty will occur in the following year of assessment.

[37] Section 102(1)(*b*) of the TA Act.

[38] Section 102(1)(*e*) of the TA Act.

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- There will only be scope for a diminution of cost price if the events in question have led to the cost price of the goods ceasing to be a proper measure of their value.
- The use of NRV to determine the value of closing stock under section 22(1)(*a*) is inconsistent with the principles that underpin the Act.

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Annexure – The law

Section 1(1) – Definition

"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

(iii) any consumable stores and spare parts acquired by the taxpayer to be used or consumed in the course of the taxpayer's trade; but

(*b*) does not include—

(i) a foreign currency option contract; or

(ii) a forward exchange contract,

as defined in section 24I(1);

Section 22

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: 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

(*b*) in the case of any trading stock which consists of any instrument, interest rate agreement or option contract in respect of which a company has made an election which has taken effect as contemplated in section 24J(9), the market value of such trading stock as contemplated in such section.

1(A) Where in respect of any year of assessment…

(2) 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 beginning of any year of assessment, shall—

(*a*) if such trading stock formed part of the trading stock of such person at the end of the immediately preceding year of assessment be the amount which was, in the determination of the taxable income of such person for such preceding year of assessment, taken into account in respect of the value of such trading stock at the end of such preceding year of assessment; or

(*b*) if such trading stock did not form part of the trading stock of such person at the end of the immediately preceding year of assessment, be the cost price to such person of such trading stock.

(2A) (*a*) Where any person carries on any construction, building, engineering or other trade …

(3) (*a*) For the purposes of this section the cost price at any date of any trading stock in relation to any person shall—

(i) subject to subparagraphs (iA) and (ii), be the cost incurred by such person, whether in the current or any previous year of assessment in acquiring such trading stock, plus any further costs incurred by such person, in terms of IFRS (in the case of a company), up to and including the said date in getting such trading stock into its then existing condition and location, but excluding any exchange difference as defined in section 24I(1) relating to the acquisition of such trading stock;

(iA) include an amount that has been included in that person's income in terms of section 8(5), which was applied in reduction or towards settlement of the purchase price of that trading stock;

(ii) in the case of any trading stock which is in terms of paragraph 12(2)(*c*) of the Eighth Schedule treated as having been acquired at a cost equal to the market value, be that market value; or

(iii) in the case of— …