

**IN THE TAX COURT OF SOUTH AFRICA**

**HELD AT PORT ELIZABETH**

Case No.: 13539/13673

Date Heard: 19 May 2017

Date Delivered: 6 July 2017

In the matter between:

**XYZ (PTY) LIMITED**

Appellant

and

**COMMISSIONER FOR THE SOUTH AFRICAN  
REVENUE SERVICE**

Respondent

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**J U D G M E N T**

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**EKSTEEN, J:**

((Accountant Member) et (Commercial Member) concurring):

[1] This appeal emanates from a dismissal by the respondent (the Commissioner) of an objection to the assessment by the Commissioner of the appellant's tax liability for the years 2008, 2009 and 2010 respectively. The dispute turns on the interpretation and application of section 22(1)(a) of the Income Tax Act 58 of 1962 (the Act) and comes before us in the form of a special case (the special case) as envisaged in rule 33(1) to 33(3) of the Uniform Rules of the High Court, as read with rule 42(1) of the rules promulgated under section 103 of the Tax Administration Act, 28 of 2011 (the TA Act).

### Background

- [2] The appellant is a registered taxpayer under the provisions of the Act and has at all material times conducted the business of a manufacturer, importer and distributor of new and used motor vehicles, including:
- (a) vehicles produced in South Africa at the appellant's production plant situated in the Cape (local production);
  - (b) vehicles imported in fully built-up condition from the appellant's affiliated companies in other countries (FBU Imports);
  - (c) medium and heavy commercial vehicles assembled at the Cape Plant (truck and bus); and
  - (d) used vehicles drawn from the appellant's company fleet (used vehicle).
- [3] The Commissioner raised additional income tax assessments on the appellant in respect of its 2008, 2009 and 2010 years of assessment, respectively, in the amounts of R72 002 161; R24 778 855 and R5 294 643. The Commissioner justified the inclusion of these amounts in the taxable income of the appellant on the basis that their exclusion by the appellant was not warranted by section 22(1)(a) of the Act.
- [4] The appellant disputes the Commissioner's entitlement to include the said amounts in its taxable income and it accordingly objected to the assessments. The Commissioner, however, disallowed the appellant's objection and the appellant now appeals against the disallowance of the objection as it is entitled to in terms of section 3(4)(b) of the Act.

### The agreed facts relevant to the dispute

- [5] The provisions of section 22(1) of the Act to which I shall revert in greater detail later herein, require of a taxpayer who carries on a trade (other than

farming) to include in the determination of his taxable income an amount in respect of the value of any trading stock held and not disposed of by him at the end of such year of assessment. The trading activities of the appellant are recorded earlier herein. It is common cause that at the end of each of the respective years of assessment in dispute the appellant held in its possession various vehicles in each of the categories set out earlier (save for trucks and busses, which only applied in the 2008 year of assessment). Each of these vehicles constituted “trading stock held and not disposed of” as envisaged in section 22(1) of the Act. The appellant determined the amount to be so included under section 22(1)(a) of the Act on a vehicle-by-vehicle basis, i.e. an amount was determined for each individual vehicle held and not disposed of.

[6] In its calculation the appellant adopted the following approach:

6.1 It ascertained the cost price of each such vehicle as set out at the end of the year in question, in accordance with the requirements of the statement of generally accepted accounting practice referred to as “International Accounting Standard two (inventories)” (IAS2). In this regard:

6.1.1 IAS2 is identical to AC108, being the equivalent standard of generally accepted accounting practice pertaining to the valuation of inventories as adopted by the South African Accounting Practices Board prior to the years of assessment in question.

6.1.2 IAS2 is also identical to the equivalent standard for valuing inventories under International Financial Reporting Standards (IFRS) published since 2001.

- 6.1.3 The cost price of stock under the applicable standard comprises “all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition” (IAS2 para 10).
- 6.1.4 The appellant’s determination of the cost price of its trading stock in respect of the years of assessment in question is not in dispute. The Commissioner accepts that this has been determined in accordance with the generally accepted accounting practice as reflected in IAS2 and envisaged in section 22(3)(b) of the Act (as it read at the time).
- 6.2 The appellant then ascertained the “net realisable value” (NRV) of each such vehicle on the basis envisaged in IAS2. In this regard:
- 6.2.1 IAS2 (para 6) defines NRV as “the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale”.
- 6.2.2 The appellant determined the estimated selling price of the vehicles in the ordinary course of business as the average price realised from sales of the same model in the previous month (described by the appellant as the “wholesale selling price” of the vehicle). The Commissioner accepts that the wholesale selling price so determined is in accordance with the “estimated selling price in the ordinary course of business” for purposes of IAS2.
- 6.2.3 The appellant deducted from the estimated selling price various amounts (to which I shall revert below) representing the estimated costs of completion and the estimated costs

necessary to make the sale, or as envisaged in the definition of NRV in IAS2. The resultant amount constituted the NRV of the asset for purposes of IAS2.

6.3 The appellant compared the NRV so determined for each vehicle with the cost price thereof, and:

6.3.1 Where in respect of a particular vehicle the determined NRV was lower than the cost price, it included in its taxable income for purposes of section 22(1)(a) of the Act an amount equal to the NRV of that vehicle;

6.3.2 Where, on the other hand, the determined NRV of the vehicle was higher than the cost price, it included in its taxable income for purposes of section 22(1)(a) the cost price of the vehicle.

6.3.3 The various amounts referred to in paragraph 6.2.3 above which the appellant took into account in its NRV calculation (other than those forming part of the cost price) fell into the following categories:

6.3.3.1 Rework/refurbishment costs

6.3.3.1.1 These are costs anticipated to be incurred in the subsequent year in reworking or refurbishing vehicles that have suffered damage, so as to put them in a condition suitable for sale.

6.3.3.1.2 The said costs have bearing upon the category of FBU imports for each of the years of assessment in dispute and the truck and bus for the 2008 year of assessment.

### 6.3.3.2 Outbound logistics

6.3.3.2.1 These are costs anticipated to be incurred in the subsequent year in transporting the vehicle from the appellant's distribution yard to the relevant dealer.

6.3.3.2.2 The appellant is contractually liable to transport the vehicles to the dealer and to incur the relevant cost.

6.3.3.2.3 The costs are determined on the basis of actual cost experience for the previous quarter, and comprise road and rail transportation (as may be applicable) as well as costs payable to a yard management contractor.

### 6.3.3.3 Marine insurance

6.3.3.3.1 These are anticipated costs in respect of the vehicle damage/loss cover provided by the appellant's marine insurance policy, which amount would be finally determined upon the sale of the vehicle.

6.3.3.3.2 The said costs are relevant to each of the categories of vehicle, other than used vehicles in each of the years of assessment.

#### 6.3.3.4 Sales incentives

6.3.3.4.1 These are costs anticipated to be incurred in the subsequent year in fulfilment of agreements and/or undertakings to pay incentives to dealers pertaining to or arising from the sale of the vehicle.

6.3.3.4.2 The said costs are relevant to each of the categories of vehicle other than used vehicles, in each of the three years of assessment.

#### 6.3.3.5 Distribution fees

6.3.3.5.1 These are costs anticipated to be incurred in the subsequent year in fulfilment of the contractual obligation towards the appellant's holding company, ABC, under the distribution and assistance agreement between the parties (the Distribution Agreement). The Distribution Agreement grants the appellant sale and distribution rights in respect of vehicles and to arrange support services provided by ABC against the payment of distribution fees.

6.3.3.5.2 The amount payable to ABC under the Distribution Agreement is a percentage

of the wholesale selling price realised for the vehicle.

6.3.3.5.3 The said costs are relevant to each of the categories of vehicle, other than truck and bus, in each of the three years of assessment.

#### 6.3.3.6 Warranty costs

6.3.3.6.1 These are costs anticipated to be incurred in the subsequent year in fulfilment of contractual warranty undertakings to the purchaser of the vehicle.

6.3.3.6.2 The warranty undertaking is an inseparable component of the sale of the relevant vehicle and is treated as part of the specification of the vehicle.

6.3.3.6.3 The amount is based on the actual warranty cost experienced over the past 12 months in respect of the particular vehicle model derivative, nett of any anticipated recoveries from affiliated companies.

6.3.3.6.4 The said costs are relevant to each of the categories of vehicle, other than truck and bus in each of the three years of assessment.



### 6.3.3.7 M Plan and T Plan

6.3.3.7.1 These are costs anticipated to be incurred in the subsequent year in fulfilment of contractual undertakings to the purchaser of the vehicle in respect of vehicle service and maintenance plans.

6.3.3.7.2 The applicable M Plan and T Plan undertakings are inseparable components of the sale of the relevant vehicle and are treated as part of the specification of the vehicle.

6.3.3.7.3 The amount is based on the actual service and maintenance cost experienced over the past 12 months in respect of the particular vehicle model, net of any anticipated recoveries from affiliated companies.

6.3.3.7.4 The said costs are relevant only to the category FBU imports in each of the three years of assessment.

### 6.3.3.8 Road Assistance Costs

6.3.3.8.1 These are costs anticipated to be incurred in the subsequent year in fulfilment of contractual undertakings to the purchaser of the vehicle in respect of assistance required by the driver as a

result of breakdowns, loss of keys and related events.

6.3.3.8.2 The applicable undertakings are inseparable components of the sale of the relevant vehicle and are treated as part of the specification of the vehicle.

6.3.3.8.3 The amount is based on the actual roadside assistance cost experience over the past 12 months in respect of the particular vehicle brand.

6.3.3.8.4 The said costs are relevant to each of the categories of vehicle, other than used vehicles, in each of the three years of assessment.

[7] The parties are agreed that to the extent that I may find that any of these categories of costs are to be taken into account in determining the value of the trading stock on hand for purposes of section 22(1) I may also accept that the amount attributable to such category in respect of the applicable vehicles is the amount set out in the appellant's calculation.

[8] In the course of his audit, the Commissioner determined the amount which he contends had to be included in respect of trading stock in relation to each of the vehicle categories and each of the years of assessment. In doing so he accepted as correct the appellant's figures pertaining to the cost price, wholesale selling price and the various other costs taken into account by the appellant in determining the NRV. The Commissioner, however, declined to take into account any of the other costs which the appellant had taken into

account in determining the NRV, save for FBU rework/refurbishment in 2008 and 2009, marine insurance in respect of truck and bus in 2008 and marine insurance in respect of local production in 2008 and 2009 (the SARS included costs).

[9] The parties are agreed that in doing so the Commissioner recognised that an amount lower than the cost price of a vehicle should be included under section 22(1)(a) in instances where the wholesale selling price of the vehicle, less the SARS included costs (if any) was lower than the cost price. The number of vehicles which the Commissioner considered to qualify for the lower inclusion on this basis was accordingly lower than the number which the appellant had identified.

[10] A summary of the opinions of one Mr S, an accountant, was filed on behalf of the appellant. Save for one aspect of his evidence the parties have agreed that the summary may be admitted as an agreed statement of his evidence.

[11] Mr S sets out and explains the material provisions of IAS2. The essential portions of his admitted evidence, to the extent that it is material to the present dispute, is as follows:

11.1 IAS2 deals with the measurement and evaluation of inventories on hand at the end of an accounting period and it provides that inventories are to be measured at cost, or NRV, whichever is the lower.

11.2 IAS2 defines the costs of inventories as follows:

The cost of inventory shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location.

The other costs referred to in the definition are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.

11.3 IAS2 recognises that the cost of inventories may not be recoverable. In particular paragraph 28 of IAS2 foresees that inventories may not be recoverable if they are damaged, have become wholly or partially obsolete, their selling prices have declined or the estimated cost of completion or the estimated costs to be incurred in order to make the sale have increased. In the result the practice is to write down the value of stock below cost to NRV. The practice is consistent with the view that assets should not be carried in excess of amounts expected to be realized from their sale or use.

11.4 IAS2 proceeds to stipulate (paragraph 30) that estimates of NRV are based on the most reliable evidence available at the time that the estimates are made, of the amount that the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period. Finally IAS2 provides that inventories are usually written down to NRV item by item unless it is appropriate to group similar or related items.

[12] Having recorded the provisions of IAS2 Mr S expresses the following opinions which are uncontested:

1. Estimated future costs to be incurred to make the sale may be taken into account in determining NRV in accordance with IAS2;
2. Estimated future selling costs as provided for in IAS2 should therefore be included in the computation to arrive at net realisable value of each unit of stock for accounting purposes;

3. All the costs which (the appellant) took into account in claiming the NRV adjustment for purposes of its income tax computation for 2008 to 2010 were legitimate costs to be incurred to make the sale of the relevant assets for purpose of IAS2 and were therefore properly taken into account in determining the carrying value of the assets for accounting purposes.

[13] In the circumstances there is no dispute between the parties that the NRV of the appellant's trading stock held and not disposed of at the end of each year of assessment has been correctly calculated for accounting purposes in accordance with IAS2.

*The question of law in dispute*

[14] The crisp legal dispute between the parties is whether the NRV of the appellant's trading stock, calculated in accordance with IAS2 and taking account of the individual categories of costs referred to earlier herein may and should, where it is lower than the cost price of such trading stock as determined in accordance with section 22(3) of the Act, be accepted as representing the value of trading stock held and not disposed of at the end of the respective years of assessment for purposes of section 22(1)(a) of the Act.

[15] The appellant, on the one hand, contends that the amounts referred in the opinion expressed by Mr S (para 12 above) do not fall to be taken into account in ascertaining the "cost price" of inventory, but do fall to be taken into account in the diminution of value thereof for purposes of section 22(1) of the Act.

[16] The Commissioner, on the other hand, acknowledges that the concept of NRV is provided for and recognised in the IAS2 for accounting purposes, however, he contends that the concept of NRV finds no direct application for the

purposes of section 22(1) of the Act. The Commissioner contends that the amounts to be deducted from the cost price as envisaged in section 22(1) of the Act are confined to such amounts “as the Commissioner may think just and reasonable as representing the amount by which the value of such trading stock, ... has been diminished by reason of damage, deterioration, change of fashion, decrease in the market value or for any other reason satisfactory to the Commissioner”. He therefore contends that the costs identified by Mr S do not fall to be taken into account in respect of the value of the trading stock held by the appellant at the end of each year of assessment, as envisaged in section 22(1)(a) of the Act.

*The construction of section 22 of the Act*

[17] The interpretation and application of the provisions of section 22 of the Act lies at the heart of the dispute between the parties. Section 22 determines the value to be attributed to trading stock when it is taken into account in determining taxable income. The value to be attributed to closing stock is dealt with in section 22(1). Broadly it is the cost price, less any allowance that the Commissioner may consider to be just and reasonable as representing any further diminution in its value. Section 22(2) determines the value to be attributed to opening stock. The manner in which the cost price is to be determined for purposes of those sections is specified in section 22(3). (See *Eveready (Pty) Ltd v Commissioner for the South African Revenue Service* (195/11)[2012] ZASCA 36 (29 March 2012)).

[18] The material portions of these subsections remained unchanged for the three years of assessment. They provided:

**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) ..., 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 ..., 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; ...

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

- (i) ..., be the costs incurred by such person, whether in the current or any previous year of assessment in acquiring such stock, plus, subject to paragraph (b) any further costs incurred by him up to and including the said date in getting such trading stock into its then existing condition and location, ...; or
  - (ii) ...
- (a) The further costs which in terms of paragraph (a)(i) are required to be included in the cost price of any trading stock shall be such costs as in terms of any generally accepted accounting practice approved by the commissioner should be included in the evaluation of such trading stock.

[19] I have recorded earlier that the parties are agreed that the “cost price” as defined in section 22(3)(a) was correctly calculated by the appellant in accordance with a generally accepted accounting practice approved by the Commissioner. Much was made during argument on behalf of the

Commissioner of the significance of section 22(3)(b). I do not consider that section 22(3)(b) is of any assistance in determining the true construction to be placed on section 22(1)(a). The “cost price” of trading stock held and not disposed of at the end of the year of assessment serves as the point of departure for the determination of the amount which shall be taken into account in respect of the value of such trading stock. Section 22(3) defines the term “cost price”. It is the cost incurred by the taxpayer in acquiring such trading stock plus any “further costs” incurred by him up to and including the date of the end of the year of assessment in getting the stock into its then existing condition and location. The “further costs” which are to be added to the cost of acquisition of the trading stock in the determination of the “cost price” is limited in two respects. Firstly, to costs incurred in bringing it to its then existing condition and location and secondly by the provisions of section 22(3)(b). Section 22(3)(b) defines the “further costs” referred to in section 22(3)(a)(i), limited as aforesaid, as costs which are in terms of any generally accepted accounting practice approved by the Commissioner, included in the valuation of the trading stock. The definition of “further costs” contained in section 22(3)(b) is limited in its application to the calculation of the “cost price” as defined in section 22(3)(a). The parties agree that the cost price of the trading stock is correctly calculated. In the circumstances no more needs to be said of the provisions of section 22(3).

[20] I turn to section 22(1)(a). In seeking to ascertain the true construction of section 22(1) the general principles applicable to the interpretation of statutes find application. There has been some development in the law relating to the interpretation of documents in recent years. The current position was



authoritatively summarised in *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012(4) SA 593 (SCA) in para [18] where Wallis JA stated:

[18] Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors. The process is objective, not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document. Judges must be alert to, and guard against, the temptation to substitute what they regard as reasonable, sensible or businesslike for the words actually used. To do so in regard to a statute or statutory instrument is to cross the divide between interpretation and legislation; in a contractual context it is to make a contract for the parties other than the one they in fact made. The 'inevitable point of departure is the language of the provision itself', read in context and having regard to the purpose of the provision and the background to the preparation and production of the document.

[21] The material known to the legislature prior to the promulgation of the Act emerges from the history of the scheme of taxation. Prior to 1956 there was no provision in the South African Income Tax Legislation equivalent to section 22 of the Act. It was, however, a well-established accounting and business principle that trading stock held and not disposed of at the end of a

period of assessment should be brought into account by reflecting it at the lower of market value or cost. The accounting principle was accepted in the courts. In *Commissioner for Inland Revenue v Jacobshon* 1923 CPD 221 a taxpayer held a stock of wool at the end of the year of assessment. The value of the wool had however decreased to below the cost price thereof. It was held (at p. 228) that:

[t]he merchant will ... have to be assessed for income upon the basis of his actual receipts and accruals during the year of assessment and the value of the wool on hand at the end of the year of assessment.

The value of the wool, being lower than the cost of acquisition thereof, was accordingly adopted.

[22] As recorded earlier, the income tax scheme was formalised by the introduction of statutory provisions in 1956 and is now reflected in section 22 of the Act. In *Commissioner for Inland Revenue v Nemojim (Pty) Ltd* 1983 (4) SA 935 (A) at 956H-957A Corbett JA reflected on the circumstances giving rise to the introduction of the provisions now contained in section 22. He stated:

It would seem that prior to this amendment the scheme of the Act for ascertaining a person's taxable income did not, in the case of a trader, fall completely into line with normal accounting methods for determining a trading profit and drawing a trader's trading account. This was particularly so in regard to the bringing into account of opening and closing stocks. Nor did the Act indicate, when such stocks were brought into account, whether they should be reflected at cost or market value or whichever of these was the lower. ... Section 22(1) and (2) of the Act ... enact how, in the determination of a trader's taxable income, such stocks should be valued. The section appears to assume that the value of such stocks will be taken into account

and in this way to recognise what had been accepted in practice over a number of years. ...

It seems to me that the accounting methods which are indicated by s 22, and which can be applied without difficulty in the case of normal trading operations, cannot be applied without adaptation in exceptional cases.

[23] The purpose of section 22 and the background to its preparation and inclusion in the Act was carefully considered and discussed in *Richards Bay Iron & Titanium (Pty) Ltd and Another v Commissioner of Inland Revenue* 1996 (1) SA 311 (A) at 316F-317D where Marais JA recorded:

The rationale for [the trading stock] provisions is neither far to seek nor difficult to comprehend. 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 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.

[24] Later in the *Richards Bay Iron & Titanium* matter *supra* Marais JA recorded at 317D-G:

In Australia, whose system of taxation has much in common with our own in its eschewal of the assessment of tax on the profits or gains of a business in accordance with undiluted accounting principles and practices, and its preference for the assessment of tax upon the excess of assessable income over allowable deductions, the rationale for the existence of provisions broadly similar to s 22 of the South African Act has been explained by the High Court in *Federal Commissioner of Taxation v St Hubert's Island Pty Ltd (in Liquidation)* (1978) 78 Australasian Tax Reports 452. The decision is helpful in two respects. Firstly, it explains why it is necessary to take into account the value of trading stock on hand at the beginning and at the close of a tax year. Secondly, it explains why trading stock is now regarded as encompassing more than the stock of goods acquired or manufactured by a trader to be sold.

[25] The first of these issues is of significance to the present case. In that regard Marais JA proceeded at 317G-318C to state:

Because the report of the case is unlikely to be generally accessible in South Africa I shall quote extensively from it.

Stephen J (at 456) recalled that in *C of T (SA) v Executor Trustee & Agency Co of SA Ltd* (Carden's case) (1938) 63 CLR 108 at 156, 1 AITR 416 at 443, Dixon J had said:

'The basis of a trading account is stock on hand at the beginning and end of the period and sales and purchases.'

He went on to say that Dixon J had explained why it is impracticable to estimate income from trade otherwise than by means of a profit and loss account, and had added that the computation of profits from trading

'has always been upon the principle that the profit may be contained in stock-in-trade . . . '.

Stephen J concluded that only

'by taking account of stock-in-trade in the conventional way can a correct reflex of the trader's income for the accounting period be obtained',

and that the provisions in ss 28-31 of the Australian legislation were there to ensure 'such a correct reflex in the case of stock-in-trade'. Reference was also made to a passage from the speech of Lord Reid in *Duple Motor Bodies Ltd v Ostime* [1961] 2 All ER 167 (HL) ([1961] 39 TC 537) at 569-70 in which he said

' . . . long ago it became customary to take account of stock-in-trade, and for a simple reason. If the amount of stock-in-trade has increased materially during the year then in effect sums which would have gone to swell the year's profits are represented at the end of the year by tangible assets, the extra stock-in-trade which they have been spent to buy; and similar reasoning will apply if the amount of stock-in-trade has decreased. So to omit the stock-in-trade would give a false result.'

There is no reason to doubt that it was for these reasons that the South African legislation too 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. Certainly, no other reasons have been suggested. See the case of *Nemojim (supra at 956G-957A)*.”

[26] Mr **H SC**, who appeared before us for the appellant, submitted that where Stephen J had concluded that stock in trade should be accounted for “in the conventional way” he had in mind conventional accounting principles. In this, it seems to me, he is correct.

[27] This brings me to a consideration of the language in section 22(1)(a) of the Act in the context in which the provision appears. The section seeks to determine the amount which is to be taken into account in respect of the value of trading stock held and not disposed of by the taxpayer at the end of the year of assessment. It stipulates that the cost price (as defined in section 22(3)) shall be the amount taken into account in respect of the value of the closing stock, unless the value of the stock has been further diminished by reason of one of the factors listed in the section, or for any other reason satisfactory to the Commissioner. The value which must have been diminished by reason of any of the listed factors is the pre-existing value. That pre-existing value is the cost price (as defined) to the taxpayer of the relevant trading stock. (See *Richards Bay Iron & Titanium supra at 327D*.) In the event that such a diminution has occurred in consequence of any of the factors listed, or any other reason satisfactory to the Commissioner, the Commissioner is then empowered to permit the taxpayer to reduce the value of trading stock held by him at the close of the year of assessment to below the cost price (as defined in section 22(3)) by deducting an amount thought by

the Commissioner to be just and reasonable “as representing the amount by which the value of such trading stock ... has been diminished”.

[28] The first enquiry is whether a diminution in the value of such trading stock, when viewed against the cost price, has occurred. In the event that a diminution in the value has occurred the Commissioner is required to determine whether the reason for the diminution justifies a reduction in the amount to be taken into account. In the event that it does the Commissioner is required to exercise a discretion as to the amount which he considers to be just and reasonable as representing the amount by which the value of such trading stock has been diminished.

[29] The essential dispute between the parties in this matter relates to whether a diminution in value of the trading stock, when viewed against the cost price, has in fact occurred and, if so, whether the Commissioner ought to have recognised such a diminution in value for purposes of section 22(1).

*The determination of the value of trading stock*

[30] Whilst section 22 of the Act sets out a clear guideline for the manner of calculation of the cost price the Act does not prescribe any method by which to estimate whether a diminution in value has occurred. The appellant contends that the assessment of the NRV as envisaged in paragraph 28 of IAS2 constitutes an appropriate method of ascertaining the actual value of the trading stock in the hands of the taxpayer.

[31] Section 22(1) recognises a diminution in value by reason of damage, deterioration, change of fashion, decrease in the market value or any other reason satisfactory to the Commissioner.

[32] Paragraph 28 of IAS2 states that:

The cost of inventories may not be recoverable if those inventories are damaged, if they have been wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated cost of completion or the estimated cost to be incurred to make the sale have increased. The practice of writing inventories down below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use.

[33] The specific factors enumerated in section 22(1)(a) correlate with the specific factors mentioned in IAS2. All of the factors as specifically listed impact upon the amount which the taxpayer could reasonably realise for the asset in the ordinary course of trade.

[34] The legislature, however, clearly envisaged that there may be other reasons, over and above the factors listed, which may give rise to a diminution in value. Paragraph 28 of IAS2 suggests two additional reasons which could give rise to a diminution in the value of the trading stock in the hands of the taxpayer.

[35] The admitted evidence reflects the provisions of paragraph 30 of IAS2. It recognises, for accounting purposes, that the estimates of NRV take into consideration fluctuations of price or costs directly relating to events occurring after the end of the period of assessment to the extent that such events confirm conditions existing at the end of the period. Although these considerations relate to future events they are taken into account to reflect the true value of trading stock as at the end of the year of assessment.

[36] As alluded to earlier, there is no dispute between the parties that the calculation of the value of trading stock made by the appellant is in



accordance with IAS2. There is therefore no dispute that each of the categories of costs taken into account by the appellant relate to costs to be incurred to make the sale.

[37] On a careful consideration of the arguments presented to us I consider 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. The NRV, determined in this manner must be compared to the cost price, computed in accordance with section 22(3) in order to determine whether a diminution in value has in fact occurred.

[38] This is consistent with the purpose of section 22 which I have dealt with earlier herein. As was pointed out, correctly in my view, by Mr H, although the taxpayer may have converted more profits into acquiring trading stock than the trading stock can now be expected to realise, what is to be added back to taxable income is no more than the reasonably anticipated taxable income that may arise from the disposal of the trading stock in the future. This approach provides an equitable balance which avoids hardship by insuring that the taxpayer need not pay tax in the current year of assessment on more than what the stock can be expected to realise for him.

[39] The approach accords too with the Explanatory Memorandum to the 1984 Income Tax Amendment Act (which introduced the specific provisions of section 22(3)) which stated:

In terms of the provisions of Section 22(1) of the Principal Act the amount which must be taken into account by a taxpayer in respect of trading stock held and not disposed of by him at the end of the year of assessment is the cost price thereof, less such an amount as the Commissioner may think just and reasonable as representing the amount by which the value of such

trading stock has been diminished by reason of damage, deterioration, change in fashion, etc.

...

A statement of generally accepted accounting practice, known as AC108 approved by the Accounting Practices Board, states the methods of evaluation more fully and, with the exception of the references to LIFO method of valuation, is acceptable as a practical guide for the valuation of trading stock for purposes of the Income Tax Act.”

(I have recorded earlier that the parties are in agreement that AC108 is identical to IAS2.)

[40] This explanatory memorandum led De Koker: *Silke on South African Income Tax* to record at para 8.1.1.1:

Since Statement AC 108 encourages the use of the ‘first-in-first-out (FIFO)’, ‘weighted average cost’, ‘specific cost’, ‘standard cost’, ‘retail method’, or ‘net realisable value’ bases of valuation in appropriate circumstances, it seems that in practice all of these bases may be adopted by taxpayers for the purposes of s 22.

[41] Even before 1984 Corbett JA, in the **Nemojim** case, appeared to postulate, all-be-it obiter, that normal accounting methods are indicated by section 22.

[42] We were also referred to the recent case ITC1881 78 SATC 132 (para [73]) where it was stated, also obiter with reference to Meyerowitz on *Income Tax*:

In terms of section 22 of the IT Act trading stock is valued in terms of s 22(1)(a), which is in essence the lower of cost or net realisable value.”

[43] The position is further advocated in an online article published by PriceWaterhouseCoopers South Africa on 9 May 2016 in its “Synopsis: Tax

*Today April 2016*" which recorded support for the adoption of the NRV as a basis for valuation of trading stock and proceeded to state:

In effect, the commercial world has identified that one cannot ascribe a value to an asset that is greater than the net cash flow it is expected to generate for the business.

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

*The discretion*

- [45] Section 22(1)(a) provides for the Commissioner to exercise a discretion as to whether the reason for the diminution in value is satisfactory. In the event that it is, then, as recorded earlier, a further discretion arises as to the amount which ought to be permitted as a reduction to the cost price of the trading stock as being a just and reasonable reflection of the diminution in value.
- [46] In the present instance the Commissioner did not recognise that a diminution in value had occurred at all in consequence of the further costs which the appellant had taken into account in determining the NRV (compare paragraph [8] above). For the reasons set out earlier herein I consider that he erred in this regard. By virtue of the error he did not exercise his discretion. In an appeal in terms of the Act the tax court is required to make the same decision, *de novo*, as the Commissioner was required to make. Where the Commissioner was required to exercise a discretion the court of appeal is

called upon to exercise its own original discretion in that regard. (See *CIR v De Costa* 1985 (3) SA 768 (A) at 774I-J.)

[47] I have held earlier that the NRV as determined in accordance with IAS2 provides an appropriate method for purposes of section 22(1) for the determination of the actual value of trading stock at the end of the year of assessment. It follows that where this value is less than the cost price (as defined) a diminution in value has in fact occurred. There is widespread support for this method of valuation and the Commissioner ought to have recognised the diminution in value. The reason for the diminution is to be found in the reduction in the reasonably anticipated taxable income that will be derived from the disposal of the trading stock. For the reasons set out earlier this is a satisfactory reason in the context of section 22(1). Once it is accepted that the calculation by the appellant of the NRV of the trading stock in issue accords with IAS2, and it was common cause at the hearing that it did, it seems to me that it would be just and reasonable to recognise the difference between the cost price and the NRV as representing the amount by which the value of such trading stock has been diminished. In the circumstances the question of law presented to us is to be answered in the appellant's favour.

[48] In the result, the following order is made:

1. The appeal succeeds.
2. The Commissioner's additional income assessments on the appellant in respect of its 2008, 2009 and 2010 years of assessment by the inclusion of the amounts of R72 020 161; R24 778 855 and R5 294 643, respectively, are set aside.

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**J W EKSTEEN**

**JUDGE OF THE HIGH COURT**

*Appearances:*

For Appellant: Adv M W H SC instructed by Chris Baker & Associates, Port Elizabeth

For Respondent: Adv R G Buchanan SC & Adv R J Tsele instructed by State Attorney, Port Elizabeth