



## Valuation of trading stock for tax purposes

The valuation of trading stock for tax purposes has been the subject of a number of cases in recent years. The SCA ruled in favour of SARS in *C:SARS v Atlas Copco South Africa (Pty) Ltd*, where the taxpayer applied its global accounting policy as a basis for writing down trading stock for tax purposes. This judgment demonstrates the burden that rests with a taxpayer to prove a diminution in the market value of trading stock before taking a reduced value into account for tax purposes.

A number of cases dealing with the valuation of trading stock have been considered by the courts in recent years. In *C:SARS v Volkswagen SA (Pty) Ltd* ('VWSA case') the SCA held that net realisable value (NRV), as determined for accounting purposes, does not reflect the diminution of the value of stock, as contemplated in section 22(1) of the Income Tax Act. The SCA recently ruled in favour of SARS in another case in *C:SARS v Atlas Copco South Africa (Pty) Ltd* ('Atlas Copco case'). This article provides a brief review of the Atlas Copco case.

### Facts and dispute

Atlas Copco South Africa (Pty) Ltd, the taxpayer, is part of a multinational group headquartered in Sweden. It imports machinery and equipment for use in the mining and related industries in South Africa.

The group applied an accounting policy to write down stock not sold within 12 months by 50% and by a further 50% if not sold in 24 months. This same policy was applied by the taxpayer to determine the value of stock for tax purposes.

SARS disallowed this adjustment on the basis that the value of closing stock, for tax purposes, can only be reduced by: (s 22(1)(a))

"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"

### Analysis and judgment

The Tax Court described the legal dispute as being whether the NRV, if lower than the cost of the trading stock, may and should be accepted to represent the value of closing stock for tax purposes. It ruled in favour of the taxpayer and concluded that the use of NRV to determine the value of closing stock was an appropriate method that yielded a sensible and business-like result. The SCA held that,

similarly to the VWSA case, the Tax Court erred in its views that NRV provided an appropriate valuation of closing stock for tax purposes. The focus of the enquiry therefore shifted to the basis used to determine the quantum of the diminution in the value of the stock.

Ponnan JA noted that it was difficult to discern the taxpayer's basis for the diminution of value. He suggested that this was due to the fact that the taxpayer deviated from its initial reliance on the group policy applied to determine NRV, which had been largely negated by the judgment in the VWSA case in the SCA.

The court considered the method and supporting evidence used by the taxpayer to determine the diminution in the value of 6 stock categories. It concluded in each instance that the taxpayer failed to provide demonstrate of a diminution in the value of the closing stock. Instead, the bases for such write-downs were described as unmotivated guesstimates, to be based on an aggressive accounting write-down policy rather than a true reflection of the factual position and, in the case of demostock, to reflect the auditor's inability to locate the stock rather than a diminution in value of the stock.

### What can other taxpayers learn from this case?

If the value of closing stock, as taken into account for tax purposes, is reduced below its cost, the taxpayer should be able to provide evidence of the decrease in the market value of the stock. Mere reliance on an accounting policy is not sufficient grounds to reduce the value taken into account for tax purposes.

Wallis JA, at paragraph 46 of the judgment in the VWSA case, stated that the *fiscus* is concerned with the value of trading stock as a whole. This statement could be interpreted that section 22(1)(a) should to be applied to a taxpayer's overall stock position. Paragraph 22 of the judgment in the Atlas Copco case would however suggest that it is appropriate to apply section 22(1)(a) to each category of stock item, rather than its overall stock position.