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Tax Implications of Trading Stock Valuation: Analysis of Section 22 of the Income Tax Act and the Commissioner's Discretion

Dissertation by

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Abstract

This dissertation explores the complexities and legal intricacies involved in valuing closing trading stock under South African tax law, specifically focusing on Section 22(1) of the Income Tax Act. The research question centres on how taxpayers should appropriately value trading stock at the end of the fiscal year in accordance with tax laws, while contrasting these practices against international standards such as the International Accounting Standard (IAS) 2. Through an examination of two pivotal Supreme Court of Appeal cases, Volkswagen and Atlas Copco, the dissertation assesses the legal boundaries and practical applicability of these valuation methods to answer the following questions:

- What factors must South African taxpayers consider demonstrating that the trading stock has decreased in value at the end of the fiscal year?
- How does Section 22(1) of the Act differ from IAS 2, and based on those differences, to what extent is it appropriate to apply IAS 2?
- How effectively can international accounting standards, such as IAS 2, be aligned with domestic tax regulations, particularly when companies adhere to global group policies that may not fully reflect local requirements?
- How does the discretion granted to tax authorities affect their decisions to approve or disallow various inventory valuation methods, and what impact does this have on maintaining consistency in tax treatment?

Findings from the research indicate that Section 22 mandates a backward-looking only approach to year-end tax valuations of trading stock, requiring reductions in stock value to be based only on actual, historical occurrences within the tax year. These include damage or market changes but not forward-looking projections used in accounting practices such as Net Realisable Value under IAS 2. The Supreme Court of Appeal (SCA) rulings emphasised the necessity for tax assessments to align strictly with Section 22's requirements, rejecting the applicability of NRV in determining tax deductions. This dissertation suggests that aligning tax

regulations more closely with accounting standards, akin to practices in the UK, could diminish inefficiencies and discrepancies, and provide clearer guidelines.

In conclusion, the dissertation reinforces the notion that the valuation of trading stock for tax purposes must reflect past and verifiable events and adhere to the prescriptive framework of South African tax law, distinct from the anticipatory nature of accounting standards. This ensures compliance with tax laws, prevents speculative deductions, and upholds the integrity of taxable income calculations.

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Chapter 1: Introduction and Background

1.1 Introduction

Section 22 of the Income Tax Act No 58 of 1962 (the Act) has seen numerous legal and legislative developments. Simply put, its primary function is to serve as a timing mechanism, ensuring that the deduction of trading stock by a taxpayer aligns with the income generated from the sale or disposal of that stock. Over time, the South African Revenue Service (SARS) has successfully litigated several cases against taxpayers concerning closing stock issues. This dissertation will focus on analysing two Supreme Court of Appeal (SCA) cases that involved judgments on trading stock valuation at the end of the year in accordance with Section 22 of the Act.

Companies referred to in the case law in this dissertation are owned by multinational group companies that rely on the parent company's policy/treatment in terms of writing off trading stock. The companies discussed in this dissertation have been using a global guideline from the ultimate holding entity; one used a percentage method and the other relied on Net Realisable Value (NRV); but both companies' policies referenced International Accounting Standard (IAS 2) for accounting, at year-end, for trading stock valuation. The amount of trading stock was measured, under IAS 2, at a lower cost or NRV.¹ SARS requires taxpayers to prove how they have arrived at their closing stock values.² In determining the amount of closing trading stock, SARS and the taxpayer must apply Section 22 of the Act.

In 2018, the SCA delivered a judgment in the *C SARS v Volkswagen*³ case concerning the estimation of trading stock at year-end, as outlined in Section 22(1)(a) of the Act. The core issue in this case revolves around the interpretation and application of Section 22(1)(a) of the Act

¹ <https://www.ifrs.org/content/dam/ifrs/publications/pdf-standards/english/2021/issued/part-a/ias-2-inventories.pdf>.

² Practice Note: No 36–Date: 13 January 1995.

³ *Commissioner for the South African Revenue Services v Volkswagen South Africa (Pty) Ltd* (1028/2017) [2018] ZASCA 116 (19 September 2018).

concerning the valuation of closing stock for tax purposes. The taxpayer, Volkswagen, argued that it should be permitted to report the value of its trading stock at an amount lower than its cost, based on the NRV as calculated according to IAS 2. The company argued that NRV could be applied to alter the valuation of inventory items when their NRV was less than the cost, influenced by market fluctuations and anticipated selling expenses, in accordance with IAS 2. Volkswagen aimed to employ NRV to secure a deduction resulting from the reduced value of inventory, thereby affecting its taxable income.⁴

In 2019, the SCA delivered its judgment in *C SARS v Atlas Copco*.⁵ In its ruling the SCA relied heavily on the Volkswagen court case. At issue in the Atlas Copco court case was whether the percentage method was satisfactory to determine the value of the stock for year-end purposes under Section 22 of the Act that deals with the valuation of trading stock.

A further issue that arises in the interpretation and application of Section 22 of the Act is the extent to which the Commissioner's discretion influences tax outcomes. The Commissioner is empowered to exercise judgement in determining whether the valuation methods used by taxpayers are acceptable for tax purposes. This discretionary authority introduces a level of subjectivity that can significantly affect the consistency of assessments, particularly in cases involving complex or foreign-influenced inventory valuation policies. Understanding how this discretion is applied—and how it has been treated in case law—is essential to evaluating the broader implications of Section 22 of the Act and its enforcement.

1.2 Background

Section 22 of the Act outlines how taxpayers should treat trading stock, mandating that companies include their closing stock when calculating taxable income. According to this section, the trading stock's value to be included should be determined as the cost reduced by an amount deemed fair

⁴ *Volkswagen* (n 3) para 4.

⁵ *C SARS v Atlas Copco South Africa (Pty) Ltd* (834/2018) [2019] ZASCA124 (27 September 2019).

and reasonable by the Commissioner. In determining this reduction in the stock's value factors such as fashion changes, a decline in market value, or other justified reasons as considered appropriate by the Commissioner to be taken into consideration. This dissertation will provide a summary and critique of the judgments in the two SCA court cases, Volkswagen and Atlas Copco, that pertain to the requirements of Section 22 of the Act.

In the Volkswagen case, the decision regarding the determination of closing trading stock at the end of the fiscal year was not favourable to the taxpayer's tax treatment. The SCA agreed with SARS that taxpayers are not permitted to use IAS 2 as a proxy for Section 22 of the Act. This judgment held that IAS 2 does not satisfy s 22(1) of the Act for trading stock's valuation for tax purposes under Section 22 of the Act and for IAS 2 purposes under the International Financial Reporting Standards (IFRS). In the Atlas Copco case, the SCA extensively referenced its 2018 decision in the case of *C SARS v Volkswagen South Africa (Pty) Ltd* (1028/2017) [2018] ZASCA 116 (19 September 2018). Similar to the Volkswagen case, the central issue in the Atlas Copco matter was how IAS impacted the application of Section 22 of the Act, which relates to trading stock valuation.

While Section 22 does reference IFRS for the purposes of other subsections, it does not do so in Section 22(1) of the Act. The inclusion of IFRS⁶ references in the Act is a relatively recent development, yet for years this section has required the inclusion of expenditure related to bringing the trading stock to its present state and location in Section 22(3) of the Act.

The primary issue raised by the SCA in the two court cases is about determining how Section 22 of the Act mandates trading stock to be reported at year-end. This involves taking into account the timing of when the trading stock was bought and any reduction in its value incurred after its purchase. As a reference, Section 22(3) of the Act⁷ states that it is 'the cost that the taxpayer incurs to acquire the trading stock, whether in the current or any previous year, plus any additional

⁶ <https://www.ifrs.org/issued-standards/list-of-standards/>.

⁷ *Volkswagen* (n 3).

costs incurred to bring the stock to its current condition and location, according to IFRS (for companies). This excludes any exchange rate differences related to the acquisition’.

It is evident that the expenses a taxpayer incurs in acquiring trading stock are deductible under Section 11(a) in the year that the stock is obtained.⁸ If the trading stock is not yet sold at the end of the year, the taxpayer will have to rely on Section 22(1) of the Act. However, proceeds from the sale of the trading stock will still be part of the gross income as it is of revenue nature.

This study arises from the fact that only limited research has been conducted on how taxpayers may value trading stock at the end of the fiscal year with regard to tax laws in South Africa. It is of utmost importance to ascertain the diminished value of trading stock to determine a consistent method for the taxpayer and SARS to use when determining the closing stock at the end of the year. As indicated above, this research will focus on the two court cases that deal with the issue, being Volkswagen⁹ and Atlas Copco¹⁰. It will conduct a critical review thereof.

1.3 Research Objectives and Questions

The aim of this research is to gain a deeper understanding of the methods that are acceptable in South Africa for valuing trading stock at the end of the fiscal year for tax purposes. This includes identifying best practices and considering international approaches to the identified issue.

To address this overarching objective, the following specific research questions need to be answered:

- What factors must South African taxpayers consider to demonstrate that the trading stock has decreased in value at the end of the year?

⁸ De Koker A.P., & Williams R.C. (2022) *Silke on South African Income Tax*, (Electronic Ed.) Chapter 8.111.

⁹ *Volkswagen* (n 3).

¹⁰ *Atlas Copco* (n 5).

- What are the differences between Section 22(1) of the Act and IAS 2 and, based thereon, to what extent can IAS 2 be used?
- In what ways does the flexibility afforded to tax authorities influence the acceptance or rejection of different inventory valuation methods, and what are the implications for consistency in tax treatment?
- To what extent can internationally accounting standards, such as IAS 2, be harmonised with local tax requirements, especially when companies follow global group policies that may differ from domestic expectations?

According to Section 102(1) of the Tax Administration Act (TAA), it is the taxpayer's responsibility to ensure that the decrease in the value of trading stock at the end of the tax year can be justified to the satisfaction of the Commissioner, as outlined in Section 22(1)(a). Each situation will be assessed based on its unique facts and circumstances.

Beyond the technical aspects of valuation and the legal precedents cited, it is important to recognise the influence of administrative judgement in tax determinations. The authority vested in the Commissioner allows for interpretive flexibility when assessing value, which can lead to varied outcomes depending on the context and complexity of the transaction. This element of discretion plays a pivotal role in shaping how valuation principles are applied in practice and may significantly affect the consistency and fairness of tax assessments.

1.4 Research Methodology

The information used in this study was obtained as follows:

- The Income Tax Act, No 58 of 1962
- International Accounting Standards
- Case law applicable to the research, with Supreme Court of Appeal rulings up to the 2023 amendments¹¹

¹¹ There are not any Constitutional Court cases on this matter.

- Books
- Electronic resources – Internet
- Journals
- Published articles

A qualitative research method has been selected for the dissertation because it is the most appropriate for determining and analysing the legal position related to the specified issues.

The chapters below address the following:

- Chapter 2 covers ‘closing stock’ for the purposes of Section 22(1)
- Chapter 3 covers what is meant by ‘*Commissioner may think **just and reasonable***’ as for closing stock write-down of trading stock at year-end
- Chapter 4 is an analysis of the Volkswagen case
- Chapter 5 entails the Altas court case analysis
- Chapter 6 covers the difference between trading stock using NRV with IAS 2 and the interpretation in Section 22(1) of the Act.
- Chapter 7 examines the valuation methods of trading stock in Brazil, Botswana, Tanzania, Malawi and other developing countries, and in the United Kingdom, representing a developed country.
- Chapter 8 reveals the conclusions of the research, providing answers to the proposed research questions.

Chapter 2: Closing Stock

This chapter concentrates on trading stock valuation and outlines the factors to consider when handling trading stock at the end of the fiscal year.

Section 22 of the Act determines the amount to take into account as the value of trading stock at the end of each year of assessment for the purpose of determining the taxable income of any person carrying on any trade (farming and financial instruments are dealt with differently).

It states that it is the **cost price** 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**.

Section 22 of the Act identifies four specific situations that can lead to a reduction in the value of trading stock: damage, deterioration, change of fashion, and reduction in market value.

However, the section also allows for the possibility of other reasons causing a decrease in value. It grants the Commissioner the authority to make a fair and reasonable decision to account for a diminution in value for other reasons deemed satisfactory by the Commissioner.

The Act does not define what is meant by the words 'diminished', 'damaged', 'deterioration', or '*change of fashion, decrease in the market value or for any other reason satisfactory to the Commissioner*'. Since the Act does not define what is meant by these words, this study relies on their general meaning as well as other publications and court cases to define these terms.

The Oxford Dictionary¹² defines 'diminished' as 'make or become less'; 'damage' as 'physical harm caused to something that makes it less attractive, useful, or valuable'; and 'deterioration'

¹² <https://www.oed.com/?tl=true>.

as ‘the fact or process of becoming worse’. The taxpayer carries the responsibility of demonstrating that the trading stock has deteriorated by the end of the fiscal year¹³, ‘a change in fashion and decrease in market value’. As previously stated, only decreases in cost below the cost price of trading stock will be considered when determining the amount of closing stock at the end of the assessment year. The Commissioner’s discretion will be discussed in the next chapter.

As an example of what would be acceptable as a ‘diminution in value’ of closing stock, the Draft Interpretation Note¹⁴ explains that certain inventory items must be sold or utilised within a specific timeframe from their manufacturing, production, or packaging date due to their limited ‘lifespan’ or ‘shelf life’. Such items typically display either or both ‘sell by’ and ‘best before’ dates on their packaging. As time passes, these items may lose effectiveness or suitability for their intended purpose, often affecting their value, as they might only sell if offered at a lower price.

Additionally, a ‘sell by’ date might influence buyers’ decisions, leading them to choose products with later ‘sell by’ dates over those with earlier ones. As a result, larger quantities of inventory with shorter shelf lives might remain unsold at the end of the assessment year, potentially necessitating price reductions to facilitate sales. Thus, there could be a decline in value. Moreover, the condition of inventory can degrade during transit or storage. For example, a shipment of first-grade rice may undergo heating while at sea, requiring it to be downgraded to second or third grade, which are valued lower than first-grade rice.¹⁵

After the Volkswagen and Atlas Copco SCA rulings between C SARS, Volkswagen and Atlas Copco, respectively, taxpayers are left unsure of how the discretion will be applied by the Commissioner when it comes to accounting for trading stock at year-end for tax purposes and whether, and to what extent, IAS 2 can be used to calculate trading stock at the end of the fiscal

¹³ Tax Administration Act of 2011 s 102.

¹⁴ [chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.sars.gov.za/wp-content/uploads/Legal/Drafts/Legal-LPrep-Draft-2024-41-Draft-IN-Diminution-in-the-value-of-closing-stock-2-October-2024.pdf](https://www.sars.gov.za/wp-content/uploads/Legal/Drafts/Legal-LPrep-Draft-2024-41-Draft-IN-Diminution-in-the-value-of-closing-stock-2-October-2024.pdf) para 4.1.1.

¹⁵ *Volkswagen* (n 3).

year. It is important to determine what has caused the trading stock to diminish in value or to have facts determining how, and the extent to which, the trading stock has diminished at year-end in terms of Section 22 of the Act.

Section 22(1) of the Act mandates reversing the deduction for the closing stock remaining on hand at the end of the year. Thus, the addition of the closing stock effectively reverses the Section 11(a) deduction on purchase of that stock until the beginning of the next year. This closing stock is then recognised as the opening trading stock for the following year by deducting it once more in terms of Section 22(2)(a) of the Act¹⁶

Since the opening value of trading stock is not considered an allowable deduction under Section 11(a) of the Act, and the amount of the closing stock does not count as income or accrual of gross income, it cannot be included as such. Thus, Section 22 of the Act provides the mechanisms for dealing with trading stock and taxable income, stipulating that *'the value of the closing stock should be added to taxable income, while the value of the opening stock should be deducted' which 'corresponds with recognised accountancy practice'*¹⁷.

The aim of Section 22 of the Act was thoroughly examined by the Appellate Division in the Richard's Bay Iron & Titanium case¹⁸, where the court provided key observations on the rationale for the provision's inclusion in the Act. It provided key observations on the rationale for the provision's inclusion in the Act. It advised that the reason for these rules is clear, being that when a trader buys trading stock, the cost is deductible under section 11(a) of the Act because it is an income-generating expense, not a capital expense. The money made from selling this stock is counted as part of the entity's gross income.

It further indicated that in a simple case where a trader buys and sells all their stock within the first year, everything matches up perfectly. The income from sales and the expenses from

¹⁶ Ibid. s22(2)

¹⁷ De Beers Holding (Pty) Ltd v Commissioner for Inland Revenue (127/85) [1985] ZASCA 86.

¹⁸ Richard's Bay Iron & Titanium (Pty) Ltd and Another v Commissioner for Inland Revenue 58 SATC 55.

buying and selling the stock balance each other, showing an accurate picture of that year's trade and there won't be any remaining stock to deal with at the end of the year.

Section 22 of the Act serves to counterbalance deductions made under Section 11(a) of the Act for trading stock acquired during the year but not sold by the end of the assessment period. Any unsold trading stock at year-end must be included in gross income at its cost price, subject to adjustments for any reduction in value that the Commissioner considers fair and reasonable. Such reductions may result from factors like damage, wear and tear, obsolescence, market value decline, or other acceptable reasons as determined by the Commissioner.

Section 22(3)¹⁹ determines the cost price of trading stock as the cost incurred by a taxpayer in purchasing the stock whether in the current or any previous assessment year. This includes any additional costs required as per IFRS for companies to bring the trading stock to its present state and location but does not recognise exchange differences related to acquiring the stock. Additionally, it is not acceptable to use the Last In First Out (LIFO) method to determine the cost, which assumes the last acquired item is the first disposed of after acquisition²⁰.

An amendment to Section 22(1)(a) of the Act was introduced in the Taxation Laws Amendment Act, 2015, and was set to become effective on 16 January 2016, up to a date specified by the Minister of Finance through a notice in the Gazette.

The amendment to Section 22(1)(a) of the Act includes the phrase 'any other reason satisfactory to the Commissioner', which provides the Commissioner with discretionary authority to approve various factors that may lead to a decrease in value.

If a taxpayer sells all their stock early in the year and makes a big profit and then just before the end of the tax year, they buy a large amount of new stock, should the taxpayer be entitled to deduct the cost of this new stock from their income without recognising that it still owns its value, they could avoid paying taxes on some or all of that year's income.²¹

¹⁹ The Income Tax Act of 1962 ss 22(3) & (3A).

²⁰ Ibid. s 22(5).

²¹ *SARS v South African Custodial Services (Pty) Ltd* 2012 (1) SA 522 (SCA) para 39.

This approach could theoretically be repeated indefinitely, allowing the taxpayer to defer their tax liability year after year until trading activities eventually cease, at which point the tax obligation would arise. Furthermore, when determining the cost of trading stock, the use of inventory valuation methods such as LIFO²²—which assumes the most recently acquired items are sold first—is not permitted under South African tax law.²³

In this context, the phrase ‘amount ... by which the value of such closing stock ... has diminished’ refers to the decrease in the cost price of the closing stock, attributed to one of the specified reasons.

In any given assessment year, there is a relationship between the trading income a taxpayer earns and the expenses incurred that year for purchasing and selling trading stock. The Volkswagen case illustrates that some trading stock purchased during the year remained unsold by year-end and that this stock would be sold in future.

The following hypothetical example is provided to illustrate this concept. Consider a taxpayer who sells toys. In 2021, they bought 2 000 toys for R150 each. They could sell each toy for R200 and had a December year-end. They also spent R4 000 on packaging and delivering the toys.

Initial cost:

Buying the toys: 2 000 toys x R150 each = R300 000

Packaging and delivery: R4 000

Total cost: R300 000 + R4 000 = R304 000

Each toy then costs:

²² *Richards Bay Iron & Titanium* (n 17).

²³ The Income Tax Act of 1962 s 22(5).

Total cost / Number of toys: $R304\ 000 / 2\ 000 = R152$ per toy

The seller managed to sell 342 toys for R68 400 (342 toys x R200 selling price) by the end of 2021.

The value of the remaining toys reduced by R100 000 because new, better toys came out.

To determine the year-end value of the remaining toys while following tax rules:

Only the remaining toys are considered at year-end:

Original cost: R304 000

342 toys at a cost of R152 each have been sold, totalling R51 984

2 000 toys less the toys sold (342) = 1 658 toys remaining. 1 658 toys multiplied by the cost price of R152 is R252 016.

Subtract the decrease in value: $R252\ 016 - R100\ 000 = R152\ 016$

Section 22(1) then requires that the stock's cost less any decrease in value, is included in the tax calculation:

Therefore, 1 658 toys (2 000 toys less 342 toys sold), less the R100 000 decrease in the toys' value totalling R152 016 will be added to income as the closing stock value. This same amount and deducted in the following year as opening stock.

Section 22 of the Act is phrased in the past tense, indicating that for the taxpayer to claim the deduction the event leading to the reduction in value must have already happened.

In *Sub-Nigel Ltd* (1948:389)²⁴ it was stated that.

- The court's focus is not on whether deductions are appropriate from an accounting perspective or align with what a prudent taxpayer might consider reasonable. Instead, it is solely concerned with whether such deductions are allowed under the specific wording

²⁴ *Sub-Nigel Ltd v Commissioner for Inland and Revenue*, 15 SATC 381, 1948, p 389.

of the Act. Therefore, the determination of permissible deductions must be based exclusively on the provisions of the Act.²⁵

- In the case of Volkswagen, Judge Wallis confirmed this interpretation by stating that the phrase “value of trading stock” should be interpreted as a constructed notion that initially corresponds to the cost at which the goods were acquired. This cost forms the foundation for assessing any subsequent decline in the value of the inventory. Therefore, a proper reading of Section 22(1)(a) suggests that the cost price—not the expected or actual market value at the time of sale—should be used as the benchmark when determining any reduction in value for tax purposes.²⁶

2.1 Conclusion

Court cases and interpretations, such as the Volkswagen and Atlas Copco SCA rulings, provide insights into how the Commissioner’s discretion is applied. The aim of Section 22 is to align business expenses and income, ensuring that deductions correspond with the stock that contributes to taxable income. It adjusts for unsold stock at year-end to prevent tax avoidance by offsetting income against newly purchased stock. The act ensures a balanced accounting approach by including the value of unsold stock in income assessment.

This chapter references the Richards Bay Iron & Titanium case to illustrate the purpose behind Section 22. Moreover, it clarifies that different valuation methods, such as LIFO, are not permissible. The Volkswagen case is cited to emphasise that assessments should be based on the cost price rather than anticipated market values. Overall, the chapter highlights the complexities in stock valuation for tax purposes, emphasising the need for documentary evidence for any claimed reductions in value.

²⁵ *Sub-Nigel Ltd* (n 24).

²⁶ *Volkswagen* (n 3).

Chapter 3: Commissioner's Discretion in this Instance

3.1 Introduction

This chapter focuses on the discretionary authority of the Commissioner, with particular attention to how that discretion is applied. The analysis centres not on the outcomes of the Commissioner's decisions, but rather on the process and reasoning behind the exercise of discretion.

The Act confers various discretionary powers on the Commissioner of SARS. Historically, the Margo Commission the Margo Commission of Inquiry²⁷ of Inquiry identified 96 provisions containing around 400 paragraphs and subparagraphs that granted such powers. However, more recent developments in tax law have shifted towards limiting discretion to promote legal certainty a principle strongly advocated by Adam²⁸.

Davis²⁹ defines discretion as the ability of a public official to choose between different courses of action or inaction, within the boundaries of their authority.

In this context, section 22(1) of the Act allows the Commissioner to accept a reduction in the value of closing stock where it is "just and reasonable." This phrase implies that any claimed reduction must be fair, substantiated, and reflective of a genuine decline in value whether due to damage, obsolescence, market conditions, or other acceptable reasons. The taxpayer must provide credible evidence to justify the reduction, ensuring that the valuation accurately represents the economic reality of the stock held at year-end.

27 Report of the Margo Commission of Inquiry. (1987). RP 34/1987, Government Printer, Pretoria.

28 Huxham and Haupt 2004:2.

29 Davis, K.C. (1972). *Administrative Law Text*, (3rd Ed.), West, St Paul, Minnesota para 4.

3.2 Discretionary Powers

Meaning:

As indicated above, discretionary powers allow the Commissioner to make choices among possible actions. These powers are indicated by phrases such as ‘the Commissioner may’. The exercise of such discretion involves administrative decisions with legal consequences.

Purpose:

Discretionary powers are necessary because:

1. Not all policies can be legislated.
2. Governments need flexibility to undertake tasks without predefined rules.
3. Rules are inflexible and discretion ensures justice in individual cases.³⁰

Discretion helps Determine when the Law Applies

The Margo Commission highlighted that discretion helps avoid rigidity and unintended results, ameliorates inflexible provisions, and recognises genuine transactions while addressing tax avoidance.

Extent and Types

Discretionary Powers are Categorised into Three Types

Discretionary powers within tax legislation can generally be grouped into three categories: those where the law clearly allows for objection and appeal; those where the right to challenge is explicitly excluded; and those where the legislation is silent on whether such a right exists. These categories are examined to determine whether any form of discretionary authority may be vulnerable to constitutional scrutiny, particularly in cases where the taxpayer’s ability to contest the decision is unclear or restricted.³¹ The Commissioner’s discretion in determining what constitutes a just and reasonable decrease in stock value can lead to inconsistent

³⁰ Baxter, L. (1989). *Administrative Law*. (2nd Ed.) Juta, Cape Town para 83–84.

³¹ *KBI v Transvaalse Suikerkorporasie* 47 SATC 34.

assessments and uncertainty for taxpayers. The discretionary nature allows for subjective interpretations by the Commissioner, leading to potential inconsistencies in how different cases are handled, which might be perceived as unequal treatment under the law.

Exercising the Discretion

Discretion must be exercised bona fides, with due consideration to statutory provisions and court decisions. The Commissioner or an officer under his control can exercise these powers, and decisions can be amended within three years if all material facts were known.

3.3 Limitations

The rights guaranteed under the Bill of Rights may only be limited through laws that apply uniformly and are considered fair and appropriate within a democratic society built on principles of dignity, equality, and freedom. Any such limitation must be reasonable and justifiable, taking into account all relevant³²—

- “(a) the nature of the right;
- (b) the importance of the purpose of the limitation;
- (c) the nature and extent of the limitation;
- (d) the relation between the limitation and its purpose; and
- (e) less restrictive means to achieve the purpose.”

Legislation is not allowed to infringe upon any rights protected by the Bill of Rights unless such a limitation is expressly authorized by subsection (1) or another constitutional provision. Any restriction must be founded on laws that apply generally and must be reasonable and justifiable in an open and democratic society that respects human dignity, equality, and freedom..

³² <https://www.justice.gov.za/legislation/constitution/saconstitution-web-eng-02.pdf>.

3.4 Commissioner's Discretion

Whenever the Act includes phrases such as 'the Commissioner may', 'whenever the Commissioner is satisfied', or 'in the opinion of the Commissioner', it effectively gives the Commissioner the authority to exercise discretion³³.

Section 33 of the Constitution³⁴ sets out the right to just administrative action as follows:

1. Each individual has the right to administrative actions that are lawful, reasonable, and conducted with procedural fairness.
2. Anyone whose rights have been adversely affected by an administrative action is entitled to receive written reasons for the decision.
3. National legislation must be enacted to implement these rights and must: a) Allow for the review of administrative actions by a court or, when suitable, by an independent and impartial tribunal; b) Require the state to uphold the rights detailed in subsections (1) and (2); c) Foster effective administration.

Thus, the Commissioner must act fairly when exercising his discretion.

Section 7(3)³⁵ of the Constitution imposes limits on all rights contained in the Bill of Rights. In line with Section 36, any evaluation of these rights must lead to a result that aligns with the principles of an open and democratic society one that upholds human dignity, equality, and freedom as opposed to an authoritarian system that neglects these values. This suggests that the rights outlined in the Bill are subject to the constraints specified in this section or elsewhere in the Constitution.

33 Van Schalkwyk, L. (2004). The discretionary powers of the Commissioner for the South African Revenue Service – Are they constitutional? *Meditari Accountancy Research*, 12(2), pp. 165–183.

34 Constitution of the Republic of South Africa, 1996

35 Ibid.

When challenging the reasonableness of how discretion was exercised by a tax authority, the focus is typically placed on objective considerations—such as the extent to which the decision affects a taxpayer’s rights—rather than on subjective aspects like the intentions or personal conduct of the official involved. However, if a broader interpretive approach is taken, both the factual impact and the underlying motives may be relevant for the court to assess whether the discretion was applied fairly and within legal bounds.³⁶

If a person seeks to demonstrate the unconstitutionality of the Commissioner’s exercise of discretion, they must establish that one of the four rights has been violated and that this violation is not justifiable under the provisions of Section 36 or other parts of the Bill of Rights or the Constitution.

The Act grants the Commissioner the authority to determine the amount that may be deducted from the cost of trading stock, meaning taxpayers do not have an automatic entitlement to such a deduction. However, this discretionary decision is not absolute, it can be disputed and taken through the objection and appeal process. If the matter is escalated to the courts, the judiciary has the power to independently assess the facts and apply its own judgement, which may override the Commissioner’s original decision.³⁷ The Act allows the Commissioner to use discretion when determining the deductible amount from the cost of trading stock or what defines the diminished value of trading stock at year-end. This indicates that deductions are not guaranteed automatically. Taxpayers may contest and appeal against this discretion. Should the issue escalate to court, the court’s ruling will take precedence over the discretion of the Commissioner.

36 *S v Makwanyane and Another* (CCT3/94) [1995] ZACC 3; 1995 (6) BCLR 665; 1995 (3) SA 391; [1996] 2 CHRLD 164; 1995 (2) SACR 1 (6 June 1995).

37 Mazansky, E. (2018). Landmark case on treatment of trading stock. <https://www.werksmans.com/legal-updates-and-opinions/landmark-case-treatment-trading-stock/> Date of access: 1 July 2020.

3.5 Constitutionality

Just Administrative Action

Section 33 of the Constitution ensures that administrative actions are lawful, reasonable, and procedurally fair. It also guarantees the right to receive written reasons for actions that affect rights. Discretionary powers that are not open to objection and appeal may be constitutionally challenged if they violate these rights³⁸.

Lawful and Reasonable Action

Administrative action must adhere to all legal requirements and be reasonable both procedurally and substantively. The review process focuses on how discretion is exercised rather than the result.

3.6 Relating to the Court Case

In the *Wingate-Pearse v Commissioner for SARS*³⁹ case It was concluded that when the Commissioner is 'satisfied', it inherently implies an action with legal implications, involving the exercise of administrative discretion. For instance, with Section 11(e) of the Act, which pertains to the capital allowance taxpayers can claim for their non-manufacturing, movable capital assets, the Commissioner issues Practice Notes. These notes clarify how he or she intends to exercise his discretion, thereby providing transparency to the discretionary process⁴⁰.

Section 22 of the Act states that the Commissioner has the power to exercise his or her own discretion based on objective criteria to determine the amount by which to reduce the trading stock. This means that the Commissioner is permitted to request relevant information from the

38 Promotion of Administrative Justice Act 3 of 2000, updated to 11 October 2024.

39 *Wingate-Pearse v Commissioner for SARS* [2019] (High Court, Gauteng Division, Johannesburg) para 1

40 South African Revenue Service (SARS). (2021). Interpretation Note 47 (Issue 5): Wear-and-Tear or Depreciation Allowance

taxpayer to reach a decision, the Commissioner has effective discretion to decide which information he or she considers necessary⁴¹.

Wallis JA puts it succinctly in the *Volkswagen SCA* case that the Commissioner can only grant a just and reasonable allowance in respect of diminution in value of trading stock under Section 22(1)(a) in two circumstances, namely:

1. When an event during the tax year causes the value of the trading stock to decrease.
2. When it is reasonably certain that an event in the subsequent tax year will lead to a decrease in the value of the trading stock.⁴²

In his judgment in *C SARS v Volkswagen*, Wallis JA began by interpreting Section 22(1)(a) of the Income Tax Act and illustrated what the provision entails. He emphasised that the cost price serves as the reference point for assessing any reduction in the value of trading stock. According to his interpretation, it is the cost of the goods—not their actual or expected selling price—that must be used as the standard when evaluating any claimed decrease in value for tax purposes.⁴³

In South Africa, Practice Notes provide guidelines on the interpretation and application of tax laws for income tax and VAT but do not have the same legal authority as the tax law itself. While Practice Notes are issued by SARS to clarify specific aspects of tax legislation and offer insights into how SARS interprets and administers tax laws, they are legally binding on SARS but not the taxpayer⁴⁴. Nonetheless, Practice Note 36, like other Practice Notes, carries significant practical weight. Taxpayers and tax practitioners often rely on these notes for guidance on compliance and to ensure that their tax affairs align with SARS's expectations. Courts may also consider Practice Notes when issuing judgments, although they are not obliged to follow them.

⁴¹ Tax Administration Act of 2011 section 46

⁴² *Volkswagen* (n 3) para 18.

⁴³ *Volkswagen* (n 3) para 26.

⁴⁴ Tax Administration Act No 28 of 2011 s 5.

In Practice Note 36⁴⁵, the Commissioner advised the taxpayer of the manner in which he will exercise his discretion. The above Practice Note also quotes from Income Tax Court (ITC) case 1489⁴⁶ where it was held that:

- a) Where a taxpayer applies a percentage-based reduction to the cost of trading stock, it is essential that this adjustment is backed by historical trading data and, where relevant, post-year-end developments. Additionally, the taxpayer must clearly explain the basis for calculating the percentage used, so that the tax authority can properly assess its validity.
- b) The Commissioner for Inland Revenue is required to exercise discretion in determining the extent to which the value of trading stock has decreased. However, this discretion cannot be properly applied unless the basis on which the submitted accounts were prepared is clearly disclosed. As a result, the Act implicitly demands that such information be provided.

The case made it clear that the use of the **NRV** method, as per International Accounting Standards (IAS 2), does not automatically satisfy the requirements of Section 22(1)(a) of the Income Tax Act. The court emphasized that tax law is distinct from accounting principles, and the Commissioner must be satisfied that any reduction from cost price is **just and reasonable**, based on actual evidence of diminished value—mere reliance on accounting standards or a fixed percentage write-down is insufficient⁴⁷.

⁴⁵ Practice Note: No 36—Date: 13 January 1995.

⁴⁶ *ITC 1489* 53 SATC 99 at 104.

⁴⁷ Volkswagen (n3) para 28

3.7 Subjective versus Objective

Objective Actions

Section 22 of the Act states that the Commissioner has the power to exercise discretion based on objective criteria to determine the trading stock value reduction. Wallis JA⁴⁸ noted that the Commissioner can only grant an allowance for diminution of trading stock value if:

- An event during the tax year diminishes the value.
- It is reasonably certain that an event in the following year will diminish the value.
- Cost price is considered the criterion for an amount to be diminished. The cost incurred in acquiring and bringing the trading stock to its current condition must be objectively considered.

Subjective Actions

The term 'satisfied' inherently suggests an action that includes personal judgement and carries legal implications. This action involves the application of administrative discretion.

The Commissioner makes a judgement call on information considered necessary to make decisions regarding tax matters based on discretion. As for subjective examples in Practice Note 36 illustrates how discretion is applied when considering reductions in the value of trading stock. The Note outlines scenarios where the Commissioner may approve a percentage-based reduction, which inherently requires interpretation, judgment, and a reasoned approach to ensure fairness and consistency.

⁴⁸ *Volkswagen* (n 3) para 18.

The practical implications reflect a clear set of objective criteria laid out to reasonably determine trading stock diminishment while allowing for some discretionary judgement by the Commissioner where necessary but grounded in careful consideration of objective facts.

Diminished Value

By relying on the objective cost price, the value impact due to diminution in trading stock is reasonably quantified and verified. This gives the taxpayer a reasonable understanding of allowable deductions based on past costs, aligning expectations and compliance.

Objective differences pertain to factors that can be verified or measured using concrete evidence, such as actual purchase prices, market values, or other quantifiable metrics. The legal standards outlined in the Act provide a definitive framework and guidelines for documenting and accounting for these costs, ensuring consistent evaluation of similar trading stock among various taxpayers.

Conversely, subjective differences arise in areas that require interpretation or judgement. This might occur in scenarios where the law permits discretion in assessing the value of trading stock, possibly due to unique circumstances or differing business practices.

The purpose of the Act is to ensure that the evaluation of trading stock is as objective as possible, reducing the potential for discrepancies due to subjective interpretation. This aims to enhance transparency in tax assessments and ensure equitable treatment of taxpayers, mitigating potential disputes over valuation.

3.8 Conclusion

This chapter focused on the discretionary powers granted to the Commissioner of SARS, addressing their historical foundation, application, purpose, and the potential legal challenges they entail. These powers, historically numerous and varied, are crucial for flexibility in tax

administration but also raise concerns regarding certainty and fairness in tax law. The analysis categorises discretionary powers, examines their exercise, and the limitations posed by constitutional principles, particularly the right to just administrative action.

It emphasises the necessity for such discretion to be exercised fairly, legally, and reasonably while maintaining accountability through mechanisms such as objections, appeals, and judicial reviews. The chapter also discussed the specific context of trading stock valuation under Section 22 of the Act, illustrating the balance between objective criteria and subjective judgement in the exercise of discretion. Lastly, this chapter set out that there are explicit objection and appeal rights for all discretionary decisions impacting tax liability to enhance transparency and protect taxpayer rights.

Discretionary powers not subjected to objection and appeal can promote uncertainty and unfairness.⁴⁹

Even though the Commissioner's discretionary powers are not inherently unconstitutional, Van Schalkwyk⁵⁰ suggested that lawmakers should review the extent and severity of certain discretionary powers that are not subject to objection and appeal; no discretionary powers should be permitted where tax is involved, especially those that cannot be challenged or appealed.⁵¹

The research set out in the chapter makes it clear that it is important that legislators take the above into account when considering legislation concerning taxes because they play a key role in establishing and outlining the laws and regulations concerning discretionary powers, especially in relation to tax obligations. Their involvement guarantees that discretionary authority over tax liabilities is properly regulated and subject to oversight. This is essential to prevent

49 Boule, L.J. (1986). Administrative justice and public participation in American and South African Law, TSAR 137 at 138.

50 Van Schalkwyk, L. The discretionary powers of the Commissioner (n 33) para 4.1.

51 Bill of Rights Chapter 2 s 7(3) 1 <https://www.justice.gov.za/constitution/chp02.html>.

misuse of power and to safeguard taxpayers' rights to challenge and appeal against decisions affecting their tax responsibilities.

Chapter 4: Volkswagen South Africa (Pty) Ltd ('Volkswagen') court case

4.1 Background

Volkswagen, the South African branch of the well-known German automaker Volkswagen AG, keeps unsold vehicles categorised as trading stock at the close of each fiscal year. This inventory consists of vehicles made at the Uitenhage plant, imported models, and some used vehicles from its fleet. In line with Section 22(1)(a) of the Act, Volkswagen must evaluate this trading stock to calculate its taxable income, usually based on the cost price minus any allowance for obsolescence according to Section 22 of the Act's guidelines⁵².

In its tax returns for the years 2008, 2009, and 2010, Volkswagen used the NRV method, aligning with IAS 2 and the IFRS Accounting Handbook from the Volkswagen Group, which led to lower valuations than the cost price. Consequently, Volkswagen claimed deductions based on the discrepancies between the cost price and NRV⁵³.

When determining a taxpayer's taxable income, a trading entity can subtract from its proceeds any expenses that are not of a capital nature and incurred while producing that income. During the relevant tax years, Volkswagen earned income from the sale of motor vehicles and was thus entitled to deduct the costs related to acquiring those vehicles from its income. However, from a timing perspective, there was not a perfect correlation between the income earned in any given year and the costs incurred in manufacturing and acquiring its trading stock. Some income was generated from the sale of trading stock available at the start of the tax year. Additionally, some of the costs involved in manufacturing or acquiring motor vehicles were related to vehicles that

⁵² *Volkswagen* (n 3) para 1.

⁵³ *Volkswagen* (n 3) para 2.

remained as trading stock at the end of the tax year and would be sold in a subsequent tax year⁵⁴.

In the Volkswagen case, SARS argued based on whether the value of Volkswagen's trading stock had decreased sufficiently to justify the Commissioner's provision of a fair and reasonable allowance under the specified section. This is because the intention is to avoid any manipulation that could affect the timing and amount of tax payments by taxpayers.

Volkswagen argued that, under Section 22(1)(a) of the Act, it was entitled to report the value of its trading stock at less than the cost price. This argument was based on the NRV of its trading stock, calculated according to IAS 2, which indicated that the value of its trading stock had declined.

4.2 Audit and Initial Legal Proceedings

SARS performed an audit of Volkswagen with regards to the unsold trading stock and rejected the use of NRV for tax estimation, arguing that NRV did not follow the legislative requirements for treating trading stock, specifically Section 22(1)(a) of the Act. The disagreement over the valuation method used by Volkswagen led to SARS issuing revised tax assessments for the years in question, resulting in additional taxes for Volkswagen. Volkswagen was dissatisfied with the assessments issued by SARS which led the company to appeal against these assessments to the Tax Court.

The Tax Court determined that Section 22(1) of the Act addresses how trading stock is valued for taxation. It outlines the procedures for assessing trading stock at the fiscal year's end to calculate a business's taxable income accurately. This section ensures the appropriate trading stock value is included in the business's income to determine taxable profits correctly. However,

⁵⁴ *Volkswagen* (n 3) para 1.

the section does not specify the method by which these values should be determined. The court ruled in favour of Volkswagen, setting aside the revised assessments issued by SARS⁵⁵.

The Tax Court concluded that NRV is a suitable method to determine the actual value of trading stock at the end of the year of assessment and that an allowance should be made if the NRV is less than the cost price. This decision was challenged by SARS, as it had potentially far-reaching implications, allowing taxpayers to claim allowances for diminished stock value whenever NRV is lower than the cost price⁵⁶.

4.3 Appeal to SCA

SARS appealed against the Tax Court's verdict to the SCA. SARS contended that NRV does not correctly represent a decrease in value as intended by the section, which permits a deduction solely when the trading stock's value has decreased because of factors such as 'damage, deterioration, changes in fashion, or a drop in market value'. The valuation should be determined based on events that have already occurred by the end of the tax year, rather than on potential future occurrences.

Volkswagen argued that the NRV of its trading stock, as calculated according to IAS 2, should be accepted as representing the value of the trading stock on hand at the end of the financial year. Volkswagen claimed that this more accurately reflected a diminished value of trading stock for tax purposes. The company based its calculation on various anticipated costs such as refurbishment, outbound logistics, sales incentives, and other future expenses expected to affect the eventual sales price of the vehicles.

⁵³ *Volkswagen* (n 3) para 43.

⁵⁶ *Volkswagen* (n 3) para 54.

4.4 Legal analysis

Section 22 of the Act primarily ensures that the value of a taxpayer's trading stock corresponds with the proceeds generated from the sale or disposal of that stock. The SCA reviewed Section 22(1)(a) of the Act, which stipulates that the value of closing stock held and not disposed of must be included in the taxpayer's income at the end of the fiscal year, as mentioned in the earlier chapters. Specifically, the value of closing stock to be added should be the cost price of the trading stock minus any amount the Commissioner may allow as a reduction in the value of trading stock provided it can be shown that the decrease is due to factors such as physical damage, deterioration, changes in consumer demand or market conditions or other circumstances the Commissioner considers appropriate. The decision is based on what the Commissioner deems fair and reasonable under the specific facts presented.

The SCA, led by Justice Wallis⁵⁷, examined the application of NRV in the context of tax law versus accounting standards. The court determined that while NRV is a recognised method under IAS 2 for reflecting the expected NRV of trading stock in financial statements, tax law requires adherence to specific principles that ensure an accurate reflection of taxable income within the tax year.

Wallis JA raised several practical difficulties in accepting Volkswagen's method, including that writing down the value of the trading stock using the NRV method ignores the fact that the NRV of the remaining stock is higher than the cost price. For a company that is operating as a going concern, the overall NRV of its trading stock is likely to exceed the cost price. It would be unexpected for a solvent and profitable trading company to have an NRV that is not higher than the cost price.⁵⁸

⁵⁷ *Volkswagen* (n 3).

⁵⁸ *Volkswagen* (n 3) para 46–47.

As discussed in the previous chapters, SARS Practice Note No 36 requires full disclosure of the method used by the taxpayer so that SARS can determine if it is reasonable. If this method is adopted to determine whether the value of stock has diminished below the cost it should not only be supported by history but also, where appropriate, post-balance sheet experience. There is also an additional requirement that the approach used to arrive at the percentages should be disclosed to the Commissioner.

4.5 The SCA Highlighted Several Key Points

The Following Points were Highlighted by the SCA:

Taxation versus accounting objectives: The SCA noted that the objective of financial accounting (providing a fair view of a company's financial status to stakeholders) is different to that of tax reporting (accurately reflecting income and expenses to compute tax liability).⁵⁹

The tax assessments were focused on the events or circumstances that diminished the value of the trading stock to below its cost price during the tax year, rather than the anticipation of future costs or events, which are more relevant for accounting.

If SARS is to allow taxpayers to adjust the value of closing stock downwards based on NRV it could lead to manipulation of taxable income, as it introduces NRV, which is clearly forward-looking (see Chapter 6). It focuses on the amount a taxpayer is expected to receive upon selling the goods and thus considers the expenditures that will be incurred to complete the sale—this method is inconsistent with the principles of the Act⁶⁰.

Section 22(1)(a) of the Act provides that the value of closing stock at the end of a tax year must be included in a taxpayer's gross income. However, if the value of that stock has decreased below its original cost due to specific reasons, such as physical damage, deterioration, changes

⁵⁹ *Volkswagen* (n 3) para 50.

⁶⁰ *Volkswagen* (n 3) para 52.

in fashion, or market value decline, the Commissioner may allow a reduction in the amount included. This ensures that only the realistic value of unsold inventory is taxed. In contrast, IFRS accounting standards may allow anticipated future expenses or losses to be recognised in the current financial year, even if they are only expected to occur in the following year. This difference highlights the stricter, evidence-based approach of tax law compared to the more forward-looking nature of financial accounting.

In the judgment Wallis JA⁶¹ noted that whether the NRV can be accepted as a legitimate basis for reducing the value of trading stock under Section 22(1)(a) of the Act is not determined by its acceptance under GAAP. Instead, it hinges on whether the reduction aligns with the specific legal requirements and interpretations set out in that section of the legislation.

After examining IAS 2 and how NRV is determined, along with noting some practical issues, Wallis JA⁶² concluded that NRV usage contradicts two fundamental principles underlying the Act and Section 22(1)(a). The first principle is that taxable income is generally assessed, and tax imposed annually is based on occurrences within the specific tax year. Unlike this 'retrospective' approach, NRV is decidedly 'prospective', focusing on the anticipated amount receivable upon selling the goods, considering expenses yet to be incurred for the sale. The second principle is that employing NRV results in future tax year expenses becoming deductible in a preceding year before they are actually incurred, which contradicts the stipulation in Section 11(a) that expenses must be genuinely incurred.

Bearing these practical issues in mind, Wallis JA upheld the appeal in favour of the Commissioner, determining that the use of NRV in this context conflicted with two fundamental principles of the Act. NRV is evidently forward-looking, while the concept of taxation is backward-looking, making them incompatible.

61 *Volkswagen* (n 3) para 29.

62 *Volkswagen* (n 3) para 52.

The SCA held that the wording of Section 22 of the Act is structured in the past tense. Consequently, only events that occurred prior to the year-end can be considered to determine if the value of trading stock has decreased in value. The section does not concern itself with potential future events affecting the stock, which is a consideration of IFRS.

4.6 The SCA's Decision

After considering and discussing the relevant aspects of NRV as calculated according to IAS 2, with specific reference to the taxpayer's submissions, Wallis JA concluded⁶³ that there is a clear possibility of overlap between the provisions of Section 22(1)(a) of the Act and the principles outlined in IAS 2. Section 22(1)(a) of the Act deals with the reduction in the value of trading stock due to factors such as diminished utility, outdated fashion trends, or a decline in market value. In a similar vein, paragraph 28 of IAS 2 states that inventory costs may become unrecoverable when items are damaged, obsolete, or otherwise impaired an interpretation that aligns with the scope of Section 22(1)(a) of the Act (as discussed in Chapter 4 of this dissertation). However, the remaining provisions of IAS 2 are more forward-looking, addressing anticipated shifts in selling prices or projected increases in costs related to completion or sale. These future-oriented elements fall outside the scope of Section 22(1)(a), which is concerned with present and demonstrable reductions in value.⁶⁴

The SCA reversed the Tax Court's decision, siding with SARS. During discussions a concern emerged regarding whether any factors included by Volkswagen in its NRV calculation could validly support a claim that certain occurrences had taken place which, despite not being fully represented in the NRV, might justify an allowance by the Commissioner under Section 22(1)(a) of the Act. After thoroughly examining the elements of the NRV calculation it seems the only possible justification would have been vehicle damage, supporting the rework/refurbishment claim. However, this was a minor factor and, by itself, it would not have significantly lowered the

⁶³ *Volkswagen* (n 3) para 43.

⁶⁴ <https://www.ifrs.org/content/dam/ifrs/publications/pdf-standards/english/2021/issued/part-a/ias-2-inventories.pdf>.

trading stock's value to warrant the Commissioner granting an allowance in favour of the taxpayer.

4.7 The Implications

This SCA decision highlights the importance of distinguishing between the use of accounting principles, i.e. that Volkswagen lost the case because those principles did not align with tax requirements. It confirms that tax assessments should be based on actual data from the tax year and should not include hypothetical or anticipatory elements common in financial accounting. The Volkswagen ruling has important implications for companies in terms of how they should value their trading stock for tax purposes and emphasises the need for compliance with specific tax statutes for purposes of preparing the tax return rather than general accounting standards.

If Volkswagen had based its method on Practice Note 36 it could potentially have written down more or less trading stock. Thus, it should have used an objective test to determine how much trading stock had been diminished and given reasons why the trading stock had diminished by the end of the year. For example, it could have used a percentage based on previous years' write-offs of trading stock, although SARS might have not accepted this method (refer to the next chapter of Atlas Copco for more discussion). Or Volkswagen could have used an average based on its past write-off experience and not the group percentage Practice Note 36 shows that the Commissioner does not completely disregard the percentage method. A taxpayer needs to show that the write-down has occurred. Using the group's policy Volkswagen did not discharge the onus of proof in terms of Section 102 of the TAA, i.e. the company could not prove that the Volkswagen group policy percentage represented a reasonable diminution in value as per Section 22 of the Act.

4.8 Conclusion

Considering the arguments and evidence presented, several important considerations weigh against adopting NRV for valuing trading stock under Section 22(1)(a) of the Act. First, Section 22(1)(a) focuses on the value of trading stock at year-end, which does not align with the forward-looking approach of NRV that considers future selling prices and costs of completion. Second, applying NRV could result in a timing mismatch because the method is indeed forward-looking as it considers the estimated costs necessary to prepare and sell the stock. Allowing deductions for future expenses in the current year contradicts the principle in the Act that only expenses actually incurred in producing income are deductible.

Ultimately, the upholding of the appeal supports the Commissioner's stance that NRV may be inappropriate for tax purposes under Section 22(1)(a) of the Act, preserving the integrity and backward-looking nature of tax assessments.

The SCA's decision reinforces the principle that, for tax purposes, valuation of trading stock at year-end must be grounded in past events and actual expenses, not future projections. The judgment ensures the integrity of taxable income calculations and prevents manipulation through speculative deduction practices. The court clarified that allowances should only be based on definite past events that have already impacted the trading stock value within the tax year.

Chapter 5: Atlas Copco South Africa (Pty) Ltd Court Case

5.1 Background

Atlas Copco, a subsidiary of the Atlas Copco Group based in Sweden, mainly deals with the sale or lease and subsequent servicing of machinery and equipment, including spare parts and consumables. These items are primarily imported from Sweden for use in South Africa's mining and related industries. By the end of the tax year, Atlas Copco typically holds thousands of items of equipment, spare parts, and consumables categorised as 'trading stock held and not disposed of' under Section 22 of the Act. This trading stock is documented as inventory in Atlas Copco's annual financial statements.

The group's parent company established a policy called the 'Finance Controlling and Accounting Manual (FAM) or The Way We Do Things (WAY)', which was enforced across all group companies. According to this policy, Atlas Copco was required to reduce the value of its unsold closing stock by 50% if it had remained unsold for the past 12 months, and by 100% if unsold for 24 months.⁶⁵

The taxpayer applied its internal policy by reducing the value of closing stock using specific percentages outlined in its Financial Accounting Manual (FAM). These reductions were reflected in its 2008 and 2009 tax returns, where the taxpayer claimed that its trading stock had declined in value during those years. However, SARS challenged this approach, arguing that the write-downs did not comply with the requirements of Section 22(1)(a) of the Income Tax Act. SARS subsequently added back R30 191 000 for 2008 and R33 402 000 for 2009, treating these amounts as taxable income on the grounds that there was no actual reduction in value at year-end due to factors such as reduces value or usefulness, market shifts, or changes in consumer demand. SARS also imposed interest in terms of Section 89quat of the Act.

⁶⁵ *Atlas Copco* (n 5) para 2.

In the Atlas Copco case, the taxpayer's auditor testified that only three product lines had been sold below cost during the year, with discounts ranging between 24% and 26%. The court noted that this was significantly lower than the blanket 50% or 100% reductions applied under the group's policy. The company's auditor acknowledged that the policy was aggressive and not necessarily reflective of actual trading conditions. Although the company claimed it had substantial stock and could have used an average-based method, it relied solely on the group-wide policy without providing sufficient justification for the percentage reductions applied.

5.2 Initial Legal Proceedings

Atlas Copco appealed against SARS's additional assessments to the Tax Court. Atlas Copco argued that its method of reducing the closing stock value, according to the specified percentages outlined within IAS 2 and its internal policy, was appropriate and should be accepted for tax purposes.

Atlas Copco initially filed an appeal in the Tax Court focusing on a pivotal legal issue: whether the NRV of its closing stock, as determined by IAS 2, IFRS, South African GAAP, and its corporate policy, should be acknowledged as an accurate valuation of its unsold trading stock at fiscal year-end under Section 22(1)(a) of the Act. This question arises particularly when the NRV is lesser than the initial cost price. 'The Tax Court concluded that the company's policy led to a "sensible and business-like result" and provided a "just and reasonable basis" for valuing the taxpayer's stock as required by Section 22(1)(a) of the Act. This decision was based on the Tax Court's earlier ruling in the Volkswagen case, without being aware that the SCA would later overturn that decision.⁶⁶

⁶⁶ *Atlas Copco* (n 5) para 8.

5.3 Appeal to SCA

SARS appealed to the SCA following the judgment from the Tax Court in favour of Atlas Copco. The crux of the appeal was to challenge whether the taxpayer, Atlas Copco SA, rightfully applied the NRV in valuing its trading stock under Section 22(1)(a) of the Act. SARS contended that the method employed by Atlas Copco did not comply with the specific deductions allowed by the Act, which require a diminution in value for deductions claimed due to reasons such as reduces value or usefulness.

During SARS's appeal, the SCA noted that Section 22(1)(a) of the Act pertains to the value of a taxpayer's trading stock at the fiscal year-end. SARS is authorised to allow a deduction under four specific circumstances outlined in the section: reduces value or usefulness, change of fashion, decrease in market value, or any other reason deemed satisfactory by the Commissioner. As it had noted in the Volkswagen case, the court emphasised that this provision is phrased in the past tense, implying that the decrease in value must have already taken place. The task, therefore, involves retrospectively evaluating the events of the past assessment year.⁶⁷

During the proceedings, Atlas Copco acknowledged that it had not evaluated whether there was a reduction in value according to the criteria outlined in Section 22(1)(a) of the Act. Instead, the company had implemented the group's policy on ageing inventory without considering other factors. This approach, which was solely based on time, did not fully meet the provisions of Section 22(1)(a) of the Act. The policy was characterised as inflexible, standardised, and not the most dependable evidence at the time of assessing any decrease in value.

In the Atlas Copco case it was mentioned that it is sensible to consider the slow-moving and overstock categories together. The taxpayer claimed that operating within the mining industry necessitated maintaining larger than typical stock volumes to be able to fill orders quickly. While

⁶⁷ *Atlas Copco* (n 5) para 7.

this argument is theoretically sound, the taxpayer often struggled to justify the substantial stock quantities held and their related tax implications, which were divided into six categories: (i) slow-moving inventory; (ii) overstock; (iii) demo inventory; (iv) Dynapac inventory (including heavy equipment for road construction and spare parts); (v) items costed at standard prices; and (vi) goods in transit (items that needed to be returned to the Swedish parent company for various reasons), all of which were claimed to have experienced a decrease in value.⁶⁸

5.4 Legal Analysis

In *CIR v Atlas Copco South Africa (Pty) Ltd*⁶⁹ the court took the same approach, holding that section 22(1)(a) of the Act deals with the valuation of a taxpayer's trading stock at the end of the financial year. It authorises SARS to permit a deduction from the cost price through an allowance that is considered just and reasonable, under specific circumstances. The language of the provision is retrospective it focuses on whether a reduction in value has already taken place. This means the cost price must have declined prior to the submission of the tax return. The circumstances outlined in the section refer to events that occurred before the taxpayer filed their return, making the assessment a backward-looking exercise that considers developments during the relevant tax year.

The Tax Court noted that Atlas Copco's approach to valuing all trading stock groupings was based on the impracticality of individually assessing thousands of stock items at year-end. The Tax Court had recognised this reasoning, suggesting that the legislature did not intend for taxpayers to individually assess every item of closing stock under such circumstances. However, the SCA later found that the Tax Court's verdict was incorrect. SARS had not argued that the taxpayer needed to individually assess each item. Instead, SARS acknowledged that sampling is a recognised and practical approach for managing large volumes of trading stock.

⁶⁸ *Atlas Copco* (n 5) para 11 and 17.

⁶⁹ *Atlas Copco* (n 5) para 7.

However, in this particular case, the taxpayer did not apply any sampling method to support its valuation adjustments.⁷⁰

Atlas Copco's rigid policy-based write-down did not demonstrate an actual diminution in trading stock value as per Section 22(1) of the Act. The use of NRV based on future market conditions was inconsistent with the tax principle focusing on past occurrences. The taxpayer's heavy reliance on its internal group policy (FAM) lacked the necessary detailed valuation assessment, diminishing the credibility of the write-offs claimed in the SCA.

5.5 The SCA's Decision

In 2019, the SCA delivered a judgment in *C SARS v Atlas Copco*. The SCA drew heavily on its 2018 judgment in *C SARS v Volkswagen*. At issue in the case was the effects of IAS on the provisions of Section 22 of the Act, dealing with the valuation of trading stock.

The SCA found that the Tax Court had made a mistake in its judgment. It highlighted that Section 22(1)(a) of the Act requires a diminution in value to have already occurred due to specific reasons such as loss of value or usefulness, which was not the case with Atlas Copco's trading stock. The court highlighted that the Act is concerned with actual events that have occurred rather than anticipatory events or accounting practices that might predict future events.⁷¹

The SCA also criticised Atlas Copco's method of applying a fixed percentage write-down based purely on the time the trading stock had been held, without regard to the actual condition or marketability of the stock. It concluded that such a method did not align with the requirements of the Income Tax Act, which demands a more concrete demonstration of diminished value.⁷²

⁷⁰ *Atlas Copco* (n 5) para 22.

⁷¹ *Atlas Copco* (n 5) para 21 and 22.

⁷² *Atlas Copco* (n 5) para 16.

The SCA indicated that the Tax Court had erred by accepting IAS 2 and NRV as compliant with Section 22(1)(a) of the Act's requirements and ruled that the structured approach employed by Atlas Copco failed to provide a legislative-compliant valuation. The correct approach, as demonstrated, should consider substantial evidence of an actual decrease in value caused by specific, verifiable reasons.

5.6 Conclusion

The SCA's 2019 ruling in *C SARS v Atlas Copco*, relied extensively on its 2018 decision in *C SARS v Volkswagen*. The central issue pertained to the impact of IAS2 and Section 22 of the Act, particularly on the valuation of trading stock. The SCA had, for the second time within a year, reaffirmed that applying accounting standards to value trading stock, without considering the four conditions outlined in Section 22(1)(a) of the Act, is not permissible for tax purposes.

The SCA found that the Tax Court had erred in its judgment by misinterpreting Section 22(1)(a) of the Act, which requires an actual diminution in value due to specific reasons, such as Injury or harm that reduces value or usefulness. Atlas Copco had not demonstrated such a diminution. Instead, it applied an indiscriminate time-based policy for trading stock valuation that did not align with the Act's requirements. Specifically, Atlas Copco applied fixed percentages, as specified in its internal policy, to write down its closing stock and incorporated the reduced values into its 2008 and 2009 tax returns.

The court emphasised that Section 22(1)(a) of the Act focuses on actual events that have already occurred, rather than anticipatory or predictive accounting practices. The SCA criticised Atlas Copco's method of applying fixed percentage write-downs based solely on the age of stock without considering its actual condition or marketability. This approach was deemed inconsistent with the Act, which necessitates a more concrete demonstration of diminished value.

The SCA upheld the appeal lodged by SARS in the Atlas Copco tax case. The Tax Court's order was set aside and replaced with an order dismissing Atlas Copco's appeal and confirming the additional tax assessments for the 2008 and 2009 tax years. This decision implies that the court found the reasoning and method used by Atlas Copco in valuing its closing stock—which SARS had contested—did not comply with the provisions of Section 22(1)(a) of the Act.

An article by Peter Surtees⁷³ summarises the outcome of the court series that led to the final ruling in the Atlas Copco case. It highlights that the SCA reinforced the importance of adhering to Section 22(1)(a) of the Act for valuing trading stock for tax purposes. The author points out that while Atlas Copco used accounting standards to determine the NRV of its trading stock, this approach alone was not sufficient for tax compliance. The valuation must demonstrate actual reductions in value as specified by the law. The author also criticises Atlas Copco's general time-based policy for failing to account for specific legislative requirements, viewing it as too aggressive. Additionally, the author notes that the court did not directly address concerns arising from interpretations in the Volkswagen case, particularly about whether trading stock should be assessed collectively or individually for value diminutions. The author also emphasises the court's acknowledgment that sampling could be suitable for assessing large volumes of stock, but Atlas Copco did not employ this method.

⁷³ <https://petersurtees.co.za/csars-v-atlas-copco-trading-stock-and-ifrs/>.

Chapter 6: Section 22 v IAS 2

This chapter focuses on closing stock as per Section 22 of the Act and IAS 2 of the accounting standards, identifying similarities and distinctions between the tax laws and the accounting standards.

IAS 2 was introduced to establish the accounting treatment of inventories. A key concern in inventory accounting is determining the cost amount that should be recognised as an asset and carried forward until the corresponding revenues are recognised. This standard offers guidance on how to determine the cost and recognise it as an expense, including any write-downs to NRV. Additionally, it provides guidance on the cost formulas employed to assign costs to inventories.

Table 1: A summary of Section 22 and IAS 2 with information obtained from the Act and IFRS

Aspect	Section 22	IAS 2	Differences
Measurement	Must be accounted for at the cost price less such amount as the Commissioner may deem 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 market value, or any other reason satisfactory to the Commissioner.	Can be measured at lower of cost or NRV. NRV is a valuation method commonly used in inventory accounting. It assesses the total revenue an asset might generate upon sale, minus a reasonable estimate of the costs, fees, and taxes associated with selling or disposing of it.	Section 22 relies on the Commissioner's discretion on various factors for diminishing the stock's value, while IAS 2 looks at the future costs 'minus a reasonable estimate of costs' not contemplated in Section 22. IAS 2 is forward-looking while Section 22 is

Aspect	Section 22	IAS 2	Differences
			backward-looking. An event has to have occurred.
Cost price	Cost price of trading stock shall include the acquisition price of the stock plus such further costs incurred in terms of IFRS (in the case of a company) as may be incurred in getting that stock into the condition and position it is in as at the end of the year of assessment.	Costs will include the cost of acquiring the trading stock and such further costs as may be incurred in getting that stock into the condition and position it is in as at the accounting date.	Both methods are similar as they aim to capture the full cost of stock, including acquisition and additional preparation costs.
Recoverable	Damage, deterioration, change of fashion, and a decrease in market value are reasons for which the value may be diminished.	The cost of inventories may not be ' recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined '.	These two methods are similar.
	Section 22(1)(a) of the Act mandates that a taxpayer must demonstrate that in evaluating any reduction in the value of trading stock, the potential for certain unsold items to have a value exceeding their cost price should be disregarded.	It necessitates that estimates of NRV be determined using the most reliable evidence available at the time. The value of closing stock is not a precisely ascertainable	Section 22 stipulates that the event must have happened while IAS 2 relies on estimates.

Aspect	Section 22	IAS 2	Differences
		figure; rather, it is an estimated amount.	

Section 22(1)(a) of the Act addresses the reduction in the 'value of trading stock as a result of damage, deterioration, changes in fashion, or a decline in market value'.

Clause 28 of IAS 2⁷⁴ deals with NRV and explains its purpose. It says that 'The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have diminished. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale of the stock have increased. The practice of writing inventories down to NRV is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use'.

Accounting Standard IAS 2 determines how inventory should be measured. Inventory is initially measured at cost, which is the price to bring it to a selling point. This means, the measurement of inventory in accounting is through the NRV, described as the projected selling price in the normal course of business, minus the projected costs of completion and the estimated costs required to make the sale. Additional IAS 2 requirements impacting the NRV include:

- IAS 2.6, any reduction in the value of inventory to its NRV must be recorded as an expense in the financial period when the decline occurs. If that reduction is later reversed, the reversal should be reflected in the income statement during the period it happens.
- IAS 2.34 explains that NRV is not a fixed definition but rather a judgment-based estimate guided by accounting standards. This valuation is not determined by the SARS, but instead relies on professional accounting judgment.

⁷⁴ chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.ifrs.org/content/dam/ifrs/publications/pdf-standards/english/2021/issued/part-a/ias-2-inventories.pdf.

In the context of IAS 2, NRV is defined as the projected selling price during the normal course of business, less the estimated costs of completion and the estimated costs needed to make the sale, as outlined in IAS 2.6.⁷⁵

Considering both Section 22 of the Act and IAS 2 it is evident that the problem is not how to determine the extent to which stock can be written down, but that there are fundamentals in IAS 2 that are not within the scope of Section 22(1)(a) of the Act.

Section 22 of the Act necessitates the trading stock at year-end to be carried at cost '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 Injury or harm that reduces value or usefulness any other reason satisfactory to the Commissioner'⁷⁶.

As for measurement of inventories, IAS 2.10 determines that cost should include all:

- costs of purchase (including taxes, transport, and handling) net of trade discounts received;
- costs of conversion (including fixed and variable manufacturing overheads); and

The formula to calculate the cost of inventory in terms of Section 22 of the Act is almost identical to that required under IFRS. However, what is unexpected is that Section 22(1) explicitly omits any mention of IFRS, suggesting that IFRS is not applicable. The write-down below encompasses the five baseline considerations Wallis⁷⁷ referred to:

- While financial statements prepared in accordance with a group's accounting framework are essential for presenting a company's financial position to stakeholders, they do not automatically determine the tax treatment of transactions under South African tax law. The calculation of taxable income must be based on the specific provisions of the Income Tax Act,

⁷⁵ chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.ifrs.org/content/dam/ifrs/publications/pdf-standards/english/2021/issued/part-a/ias-2-inventories.pdf.

⁷⁶ Income Tax Act 58 of 1962 s 22(3).

⁷⁷ *Volkswagen* (n 3).

which may differ from accounting standards. Therefore, reliance on accounting policies alone, without reference to the requirements of the Act, may result in incorrect tax reporting.⁷⁸

- Although there may be areas where Section 22(1)(a) of the Act and IAS 2 intersect, the scope and focus of each are not entirely aligned. IAS 2 addresses a broader range of accounting considerations, whereas Section 22(1)(a) of the Act is specifically concerned with determining whether a reduction in the value of trading stock qualifies for tax purposes. Therefore, not all principles under IAS 2 are directly applicable when interpreting the requirements of the Act.
- The calculation of NRV is inherently based on projections of future market conditions⁷⁹. This forward-looking nature creates a conflict with two core principles of the Income Tax Act. First, taxable income must be determined annually, based solely on events and circumstances that have occurred within the relevant tax year. Second, applying NRV may result in deductions being claimed in a prior year for expenses or losses that only materialise in a subsequent year. This misalignment can lead to premature tax relief and undermines the timing rules embedded in the Act:⁸⁰
- According to Wallis (Volkswagen), this approach relies on management making forward-looking assessments regarding product viability and future performance. When uncertainty is significant, accurately forecasting elements such as obsolescence, defects, customer returns, price volatility, or regulatory developments becomes highly complex. From a tax perspective, this introduces challenges because anticipated future costs may be recognized in the current or preceding tax periods. Such recognition typically results from specific tax rules or adjustments that permit early treatment of expenses, even though the underlying obligations pertain to later periods. The principles outlined in the Act do not always align with modern accounting standards. As a result, whether NRV qualifies as a legitimate reduction in the value of trading stock under Section 22(1)(a) of the Act depends not on its recognition within GAAP, but rather on whether it meets the specific criteria established through a proper interpretation

⁷⁸ Volkswagen (n 3) para 31.

⁷⁹ Volkswagen (n 3) para 36.

⁸⁰ Volkswagen (n 3) para 52 and 53.

of the tax legislation. The focus remains on compliance with the Act, rather than conformity with accounting norms.⁸¹

There is a definite overlap between the provisions of Section 22(1)(a) of the Act and those outlined in IAS 2. Section 22(1)(a) of the Act addresses the diminishment in the value of trading stock due to factors such as damage, deterioration, changes in fashion, or a decline in market value. This section aligns with Clause 28 of IAS 2, paragraph 35, which also deals with aspects affecting the valuation of inventories that the cost of inventories may not be recoverable if they have been damaged or have become obsolete in whole or in part. To this extent, these two correspond. In the case of *C SARS v Volkswagen*⁸², the central issue was that the taxpayer claimed it was entitled to report the value of its trading stock at an amount below cost, as per IAS 2. Volkswagen's argument was rooted in the NRV of its trading stock, calculated according to IAS 2, asserting that the company's NRV demonstrated a diminishment in the value of the trading stock.

One of the notable features of Section 22(1)(a) is its reference to an amount by which the value of trading stock has been reduced, indicating that the provision deals with a decrease that has already occurred. The use of past tense suggests that the section is not concerned with future changes in value, but rather with assessing whether a reduction in value existed at the end of the tax year. SARS argued that any adjustment to the value of trading stock must be based on actual events or conditions that took place before the tax year closed.⁸³

Section 22 of the Act does not verify how the trading stock should be treated in the future as it is written in past tense. The future selling price can only be considered in two situations, namely:

⁸¹ *Volkswagen* (n 3) para 32.

⁸² *Volkswagen* (n 3) para 4.

⁸³ *Volkswagen* (n 3) para 16 and 17.

The first scenario arises when an event during the relevant tax year leads to a decrease in the value of trading stock. The second occurs when there is a reasonable expectation that an event in the subsequent tax year will result in a reduction in the stock's value..⁸⁴

IAS 2 deals with anticipated matters such as fluctuations in prospective selling prices, increases in the estimated costs of completion, or the projected costs of enabling sales. For instance, an unexpectedly high wage settlement, a rise in transport costs due to higher fuel prices, or a currency depreciation would increase future selling costs. These factors must be considered when determining NRV.⁸⁵

Section 22(1)(a) of the Act and IFRS are generally consistent concerning the reasons for the diminution in inventory value. IAS 2, in paragraph 28, states:

” The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined.”

Although the terms differ, they convey the same underlying idea: factors such as physical damage, wear and tear, shifts in consumer preferences, and declines in market prices are all valid reasons for a reduction in value, as outlined in Section 22(1)(a) of the Act.

IAS 2, paragraph 28, also describes further reasons recognised by the commercial world for acknowledging a reduction in inventory value:

“The key problem is if the cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased.”

⁸⁴ *Volkswagen* (n 3) para 18.

⁸⁵ *Volkswagen* (n 3) para 43.

Essentially, IAS 2 categorises reasons accepted by the commercial world: the net return, and thereby the inventory value, may be reduced due to the need to incur costs to make the inventory saleable and to finalise the sale at a particular price.

Consider, for example, IAS 2 Reduction in Market Value:

Company A bought 2 000 toys for R150 per toy (R300 000). Company A incurs transportation and insurance expenses of R40 000. For this example, let us assume at the end of the year the estimated selling price is R200 per toy and projected costs to complete and sell are R50 each. Assume no other reduction in value due to fashion, deterioration or obsolescence, among other factors, and no toys sold by year-end.

The total cost of purchase is R340 000 (R300 000 plus R40 000), i.e.

Each toy cost R170 (R340 000/2 000).

NRV at year-end = estimated selling price (R200) less estimated costs to complete and sell (R50) = R150

Since the NRV (R150) is lower than the cost per toy (R170), under IAS 2, the inventory should be measured at the lower value, which is the NRV of R150 per toy.

In conclusion, according to IAS 2, Company A should report the inventory at the net realisable value of R150 per toy, i.e. R300 000.

Using the same information as above for Section 22(1) of the Act on the basis that NRV cannot be used:

Closing Stock Value (unsold toys):

Unsold toys = 2 000 x R170 = R340 000

Summary:

Closing stock at year-end: R340 000

This is higher than when using the NRV method.

Section 22(1) of the Act emphasises the accurate valuation of closing inventory, ensuring that all costs incurred to bring the inventory to its present condition and location at year-end are included.

The Act refers to IFRS in other sections but not in Section 22(1). One can only assume that the Act does not make use of IFRS for Section 22(1) because if it intended for IFRS to be used it would have wording to this effect. See below where the Act has made reference to IFRS for tax adjustments.

Section 22(3) of the Act defines the cost price of trading stock as the total expenditure a taxpayer has incurred to acquire the stock, inclusive of any additional costs acknowledged under IFRS for companies, applicable to both present and previous assessment years. While other parts of Section 22 of the Act incorporate IFRS, Section 22(1) does not make reference to IFRS.

Such an alignment would have been consistent with the fact that IFRS are already integrated into the Act, not just in Section 22 of the Act. The term is defined in Section 1 and is referenced in for example section 11(j) 23L, 24JB, 25BB, 28, and 29A of the Act. A broader reference to, and reliance on, IFRS indicates that National Treasury considers the IFRS principles reasonable for the matters addressed in these sections.

The difference arises in the application from both a tax and accounting perspective. While IAS 2 aligns with global accounting standards and anticipates future market conditions influencing inventory value, Section 22(1)(a) of the Act remains concerned with the immediate tax implications and historical events impacting inventory value. This distinction is crucial in cases

such as Volkswagen and Atlas Copco, where the taxpayers' argument based on NRV was examined through a tax lens, emphasising historical depreciation over potential future losses.

The integration of IFRS principles is notable throughout various sections of the Act, but Section 22(1)(a) of the Act remains an exception, underscoring the distinct objectives and interpretations required for tax purposes versus general accounting practices. This points to a significant approach where tax liability evaluations must sometimes diverge from broader accounting standards to meet specific statutory requirements.

6.1 Conclusion

The chapter explored IAS 2 and compared it to the treatment of closing stock under Section 22 of the Act, focusing on similarities and distinctions between accounting standards and the tax law. IAS 2 provides guidelines for inventory accounting, emphasising measurement at cost NRV, determined by the selling price minus future costs necessary for realisation of the asset. Unlike IAS 2, Section 22 of the Act focuses on deterioration in value at year-end and relies heavily on the Commissioner's discretion for inventory valuation adjustments, i.e. differences in judgement between the taxpayer and the Commissioner can occur, especially concerning what constitutes fair and reasonable valuation adjustments for deterioration.

Both frameworks agree on including acquisition and preparation costs in inventory valuation but differ in their approach to future projections and tax implications. IAS 2 is forward-looking, aiming to reflect future market conditions on inventory value, while Section 22 is backward-looking, accounting only for past events impacting value.

The Act's Section 22(1) explicitly avoids referencing IFRS, despite the latter's inclusion elsewhere, such as in defining stock costs and other tax adjustments. This indicates a deliberate divergence from IFRS principles in inventory valuation for tax purposes, underscoring the Act's focus on immediate diminishment in value implications over future-oriented accounting standards such as IAS 2.

The chapter highlights that while there is overlap in concepts such as obsolescence Material degradation tear affecting inventory value, which appear in both IAS 2 and Section 22(1), fundamental differences arise in methodology and application, pointing to distinct objectives for tax evaluation compared to accounting practices.

There is a contentious issue concerning the different interpretations and valuation methods prescribed by the Act for tax, and IFRS for accounting. This means that the reductions in the value of stock reflected in year-end accounts do not align and adjustments must be made to reflect an acceptable tax valuation. Clearly, effecting such adjustments can be time-consuming and inefficient. Van der Zwan, P. (n.d.) indicates that taxpayers have advocated for the acceptance of IFRS valuation methods by the Commissioner for the valuation of trading stock⁸⁶.

⁸⁶ Van der Zwan, P. (n.d.) Valuation of trading stock for tax using IFRS as a basis. PvdZ Consulting. Available at: <https://tax.pvdz.co.za/788-2/> (Accessed: 22 October 2025).

Chapter 7: Other Countries' Tax Treatment of Closing Stock

In this chapter, the tax treatment by five countries across different continents will be explored. Specifically, three countries from Africa, one from the BRICS (Brazil, Russia, India, China, and South Africa) group, and one from a developed country. The focus will be on comparing how these countries treat their trading stock at year-end, identifying any similarities with South Africa, particularly relating to obsolescence.

The Public Affairs Research Institute (PARI) has produced a series of working papers titled 'The Fiscal Histories of Sub-Saharan Africa', seeking to enhance the understanding of the intertwined development of taxation systems and state-building efforts across the region. The working papers indicate that in contemporary societies, taxation plays a vital role by enabling governments to fund essential services and invest in public infrastructure. Furthermore, the design and implementation of tax policies can significantly impact a country's economic trajectory and its capacity for autonomous development. Importantly, effective tax systems also contribute to the strengthening of democratic institutions, promoting better governance and increased accountability.

Understanding the history of fiscal systems is pivotal for comprehending state capacity, institutional design, the changing relationship between the state and society, and, ultimately, the pathways to democracy. In sub-Saharan Africa today, there is a variety of taxation scenarios, shaped by the distinct historical developments in the formation and transformation of social, political, and economic institutions across the continent. Inspired by these dynamics, PARI's fiscal histories series examines the colonial and post-colonial state-building journeys of different countries in the region, emphasising the crucial role that taxation has played in these processes.⁸⁷

⁸⁷ <https://pari.org.za/fiscal-histories-sub-saharan-africa-case-south-africa-2/> page 2.

The selected African countries are Botswana, Malawi and Tanzania, representing the Southern African and East African regions, respectively. Among the BRICS nations, Brazil was chosen due to its status as a developing nation, similar to South Africa. For developed countries, the United Kingdom was selected because South Africa's tax legislation closely mirrors that of the United Kingdom.

The selected countries are analysed to understand how they account for trading stock and any value diminution at the end of the fiscal year, and to determine whether they rely on accounting standards or solely on tax legislation. This analysis will contribute to the dissertation by allowing for a comparison between countries on the same continent as South Africa, another developing nation and a developed country.

7.1 Botswana

Determination of Stock Cost on Acquisition

Botswana treats the cost of inventory as the amount paid to procure goods, including all direct expenses related to acquisition. Companies are expected to follow recognized accounting practices such as IFRS, where stock cost incorporates purchase price, transport, import duties, and other necessary costs to place inventory in a resalable state.

Permissibility of LIFO / FIFO

Although Botswana's tax legislation does not explicitly list permitted inventory flow assumptions, tax authorities generally reject the use of Last In First Out (LIFO). Reporting is based on cost figures prepared under GAAP/IFRS, which prohibits LIFO, while First In First Out (FIFO) or weighted-average cost methods are deemed acceptable.

Treatment of Closing Stock in Profit Computation

In Botswana, the closing inventory is accounted for in the calculation of taxable profits. The closing stock figure is deducted from the sum of opening stock and purchases to determine the taxable profit, aligning with standard profit computation formulas for tax purposes⁸⁸.

Valuation Method for Closing Stock

Closing stock in Botswana must be valued at cost less allowances for damage, spoilage, obsolescence, or other impairments. This approach mirrors IFRS's "lower of cost or net realizable value" principle, ensuring a conservative and realistic stock valuation for tax purposes⁸⁹.

Conclusion

Botswana and South Africa align closely in treatment, with both emphasizing cost-based valuation, conservatism on impairment, and rejection of LIFO. South Africa, however, has a more developed legal framework and jurisprudence governing when stock impairments are permissible for tax purposes.

7.2 Tanzania

Determination of Stock Cost on Acquisition

In Tanzania, the cost assigned to inventory for tax purposes typically aligns with the cost recorded under GAAP, which follow IFRS. This means that the acquisition cost includes all direct expenses necessary to bring the stock into a usable condition and location. Unlike some jurisdictions, Tanzania does not provide explicit detailed rules for determining cost but relies on adherence to accounting norms for the valuation of inventory.

⁸⁸ Income Tax Act (ITA) Cap 52:01, First Schedule, Part 1 s 28

⁸⁹ Ibid. s 28:1

Permitted Cost Flow Methods: LIFO / FIFO

Tanzania's tax law does not explicitly prescribe acceptable inventory flow assumptions such as FIFO or LIFO. However, since taxable income is calculated based on figures prepared under GAAP, companies typically adopt FIFO or weighted-average cost methods, as allowed in IFRS. LIFO is not recognized under IFRS, and by extension it is not acceptable for Tanzanian tax purposes.

Impact of Closing Stock on Taxable Profit

The value of closing stock plays a critical role in determining taxable income. Profits are calculated using the formula of taxable Profit (opening stock plus purchases less closing stock). Thus, closing stock is treated as a deduction from income, reducing the amount of profit taxed in the period in which the stock remains unsold⁹⁰.

Valuation Rules for Closing Stock

Tanzanian tax policy requires that inventory is valued at the lower of cost or market value at the balance sheet date, paralleling the principle in IAS 2. This means that if the market value (reflecting expected sale less disposal costs) is lower than the accounting cost, the lower value must be adopted in tax reporting. This is consistent with IFRS-based national accounting standards, ensuring a conservative valuation approach⁹¹.

Comparison with South African Treatment

Tanzania and South Africa share similar principles: both reject LIFO, allow FIFO or weighted-average methods, and employ the lower of cost or market (NRV) rule. However, South Africa has a more explicit legal framework under its Income Tax Act and HMRC (SARS) guidelines, requiring taxpayers to prove permanent declines in stock value to justify write-downs. Tanzania, on the other hand, leans directly on accounting standards (IFRS/GAAP) without requiring additional tax-specific evidentiary rules.

⁹⁰ Tanzania Revenue Authority ISO 9001:2008 Certified the Income Tax Act, CAP.332 Practice Note 4.2.1(b).

⁹¹ Ibid., Practice Note 4.5.2 (ii) Principles for Specific Deductions.

7.3 Malawi

Determination of Stock Cost on Acquisition

Under Malawi's Taxation Act, Chapter 41:01⁹² Division 3 (Stock and Work in Progress), sections 47–50⁹³ apply. Stock cost is generally based on the basis concept defined for capital assets under section 2 ("basis"): cost of acquisition including purchase price and related expenses like import duties. Thus, inventory cost includes all necessary costs to bring goods into saleable condition, aligning with accepted accounting principles (e.g., IFRS).

Permissibility of LIFO / FIFO

While the Act doesn't explicitly specify acceptable cost flow assumptions, the reliance on cost or market selling value (section 50⁹⁴) implies preferred methodologies like FIFO or weighted-average cost. LIFO is not recognized in IFRS, which Malawi follows for cost definition so, in practical terms, LIFO isn't permissible under Malawi tax rules.

Tax Treatment in Malawi

Malawi's tax legislation outlines a structured approach to inventory valuation for tax purposes. According to Sections 47 through 50 of the Income Tax Act⁹⁵, mandate that both opening and closing inventories must be included in taxable income calculations. Section 48 specifies end-of-year valuation, Section 49 governs beginning-of-year valuation, and Section 50 requires stock to be valued at the lower of cost or market selling value. "Cost" mirrors accounting's concept by covering purchase and production costs, while "market selling value" aligns with NRV, representing expected sale proceeds less selling costs. This ensures inventory isn't overstated for tax purposes, which could distort the cost of goods sold and inflate taxable profits.

⁹² Malawi Government. (2006). Taxation Act (Chapter 41:01).

⁹³ Malawi Government. (2006). Taxation Act (Chapter 47-50).

⁹⁴ Malawi Government. (2006). Taxation Act (Chapter 50)

⁹⁵ https://www.mra.mw/assets/upload/downloads/Taxation_Act.pdf s47-50

Although both IFRS and Malawi's tax legislation apply the principle of valuing inventory conservatively specifically using the lower of cost or market value their approaches differ in structure and emphasis. IFRS provides comprehensive instructions on how inventory should be measured, including specific valuation techniques and the expectation of consistent application across reporting periods.

This promotes clarity and comparability in financial statements. In contrast, Malawi's Income Tax Act focuses more on the result than the process. It requires that inventory be valued appropriately but does not prescribe detailed methods for doing so. While accounting standards influence both the opening and closing inventory figures, which in turn affect reported profits, the tax framework in Malawi is more narrowly focused on ensuring that taxable income is calculated accurately.

Valuation Method for Closing Stock

Section 48 requires end-of-year valuation; Section 50 allows valuation at cost or market selling value, whichever is lower. As such, the valuation follows a "lower of cost or market" basis. However, only permanent declines (e.g., obsolescence or damage) that reflect market value reductions can justify using a lower figure.

Conclusion

Both South Africa and Malawi apply conservative principles when valuing inventory for tax purposes, but they differ in how strictly and precisely these rules are enforced.

In South Africa, taxpayers are required to provide clear and credible evidence of a permanent reduction in the value of inventory before they can claim a lower valuation for tax purposes. Temporary declines in market prices are generally not accepted as valid reasons for adjusting stock values.

Malawi, on the other hand, uses a more flexible method. It allows businesses to value closing inventory at the lower of its original cost or its current market selling price, without needing to prove whether the decline in value is temporary or permanent.

7.4 Brazil

Determining Stock Cost on Acquisition

In Brazil, the cost recorded for inventory includes the purchase price plus all expenses directly related to bringing the inventory into a saleable condition this encompasses transportation, insurance, import taxes, and other acquisition costs. These costs must be fully documented in the company's accounting records (e.g., SPED)⁹⁶.

Permissibility of LIFO / FIFO

Brazilian tax law allows companies to value inventory using FIFO or Weighted Average Cost methods. The LIFO method is explicitly disallowed, and companies must maintain consistent valuation methods across reporting periods.

Treatment of Closing Stock in Profit Calculations

For tax purposes, closing stock does not directly alter taxable income at year-end but plays a crucial role in determining trading profits. Closing stock is deducted in the profit calculation formula (opening stock plus purchases less closing stock), thereby influencing taxable income in the period when goods are sold.

Valuation Method for Closing Stock

Inventories in Brazil must be valued at the lower of cost or market value, where market value is interpreted as the probable selling price minus estimated costs such as profit margins and completion expenses. This rule is analogous to IFRS/IAS 2 "lower of cost and NRV" and is enforced through the SPED system.

⁹⁶ https://www.planalto.gov.br/ccivil_03/LEIS/L0154.htm#art2.

Comparison with South Africa

Like Brazil, South Africa forbids the LIFO method and mandates valuation of closing stock at the lower of its cost or its net realizable value. A key distinction lies in Brazil's digital integration via SPED which enhances transparency and enforcement of these rules. South Africa relies more on case law and taxpayer-supplied evidence to ensure conservative and justified inventory valuation.

Conclusion

In Brazil, inventory valuation at the end of the fiscal period must adhere to strictly regulated methodologies under tax legislation. Companies using the actual profit regime are permitted to value stock either by the average cost of all units or by the cost of the most recently produced or acquired items, and they may also apply a projected sales price minus profit margin approach when it results in a lower value⁹⁷.

Furthermore, Brazil's SPED mandates fully integrated and digitized records encompassing both inventory movements and valuation methods to enable continuous verification by the tax authority (RFB). This integration ensures transparency, data accuracy, and compliance with valuation standards⁹⁸.

In comparison to South Africa, which also values stock at the lower of cost or market value, Brazil's framework is distinguished by its explicit allowance of projected sales-price methods and its reliance on digital record-keeping through SPED. While both countries employ a conservative valuation principle, Brazil places greater emphasis on digitized integration and allows a broader set of acceptable valuation approaches under its national legislation and accounting pronouncements, reflecting partial alignment with IFRS but shaped by its own regulatory structures.

⁹⁷ <https://taxsummaries.pwc.com/Brazil/Corporate/Income-determination>

⁹⁸ <https://taxsummaries.pwc.com/Brazil/Corporate/Income-determination>

7.5 United Kingdom

Determination of Stock Cost on Acquisition

In the United Kingdom (UK), the initial cost of stock is based on the total amount paid to procure the goods and bring them to their present condition and location. This includes the purchase price, import duties, transport costs, and other directly associated expenses. This foundational cost forms the basis for subsequent tax treatment of inventory⁹⁹.

LIFO and FIFO: Which Methods Are Permitted?

The UK tax system prohibits the use of LIFO for stock valuation, as it does not accurately reflect profit for tax purposes. Instead, taxpayers typically use FIFO or weighted-average cost methods under both tax rules and FRS 102 accounting standards.

Treatment of Closing Stock in Tax Computation

Closing stock is deducted from costs in calculating trading profits, according to the formula is opening Stock plus Purchases less Closing Stock. This means that unsold inventory at year-end reduces taxable profit in the period when it was not sold, in line with established tax case law.

Valuation of Closing Stock

For tax and accounting purposes, stock must be valued at the lower of cost or NRV. NRV is defined as the amount the goods could be sold for, minus any expenses necessary to complete and sell them. This conservative approach is outlined in HMRC's Business Income Manual and is consistent with FRS 102¹⁰⁰ and traditional GAAP practices.

Comparison with South Africa

⁹⁹ <https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim33100>

¹⁰⁰ <https://www.frc.org.uk/library/standards-codes-policy/accounting-and-reporting/uk-accounting-standards/frs-102/> section 13

Like the UK, South Africa prohibits LIFO, and both jurisdictions mandate valuation of inventory at the lower of cost or market/NRV. However, South Africa typically requires taxpayers to demonstrate permanent declines in inventory value to qualify for write-downs, whereas the UK focuses on using observable market data and maintains alignment with IFRS and FRS guidance on periodic inventory valuation.

7.6 Conclusion

This chapter reveals how different countries employ diverse methods to assess the value of trading stock at the end of the fiscal year. Although some methods are similar, there are notable variations in their valuation approaches

The chapter conducted a literature review to compare South Africa's tax closing trading stock valuation treatments with those of other countries, identifying principles of a good tax system and areas for improvement in South Africa. The chapter reveals that different countries employ diverse methods to assess the value of trading stock at the end of the fiscal year. Although some methods are similar, there are notable variations in their valuation approaches.

The chapter highlights the need for better guidance and clear definitions from SARS to reduce uncertainty and increase efficiency and to align more with international norms.

Countries with Similarities to South Africa:

Botswana shares a similar approach to South Africa in valuing closing trading stock for tax purposes. Both countries rely on the incurred cost to determine stock value and allow adjustments for certain events such as damage or obsolescence at year-end. Tax authorities have a discretion over these adjustments.

Tanzania and South Africa both use the initial cost and closing values of trading stock, to account for reductions in value at year-end. All countries allow inventory valuation at the lower

of cost or market value, similar to South Africa's cost-focused approach under Section 22, which allows specific diminishments. All countries exclude LIFO, which is similar to South Africa.

Countries with Differences:

Brazil utilises specific national standards somewhat aligned with IFRS, which reflect their regulatory and operational practices, it incorporates IFRS principles to a greater extent than South Africa, for year-end valuation.

Malawi provides flexibility in valuations by allowing for the inclusion of future selling costs, subject to agreement with the Commissioner. This approach differs from South Africa's more strict guidelines under Section 22 of the Act.

This chapter thus highlights that while some structural similarities exist, each country's fiscal policies and adherence to international standards introduce distinctive differences in their treatment of trading stock valuation. Different countries employ diverse methods to assess the value of trading stock at the end of the fiscal year. Although some methods are similar, there are notable variations in their valuation approaches.

Of interest is that some developing countries as well as developed countries sanction the use of accounting standards to determine the year-end value of trading stock and this raises the question as to why South Africa does not consider its use appropriate.

In summary, it is clear that South Africa's end of year trading stock tax legislation is more prescriptive and reliant on the Commissioner's discretion, while other countries provide more flexibility or standardisation, depending on their fiscal policies and alignment with international accounting standards. This contrast emphasises the complexities and challenges that international tax policy presents for trading stock valuation processes.

The complexities and challenges in international tax policy for trading stock valuation processes include navigating varying levels of prescriptiveness in legislation, such as South Africa's

reliance on Commissioner discretion versus more standardised approaches elsewhere. Businesses must adapt to different fiscal policies and regulatory environments, ensuring compliance with both local tax laws and international accounting standards. This can lead to challenges in harmonising valuation methods across multiple jurisdictions, managing cross-border transactions, and addressing the potential for increased administrative burdens and costs. Additionally, differences in the interpretation and application of tax laws can create uncertainties, impacting financial reporting and strategic decision-making for multinational companies¹⁰¹.

The chapter suggests that aligning tax regulations more closely with accounting standards, similar to practices in the UK as permits IFRS and thus enables consistent treatment with accounting, could reduce discrepancies and provide clearer guidelines. It is recommended that special valuation rules be established for businesses to offer them relief, making compliance easier and more efficient.

¹⁰¹ <https://taxfaculty.ac.za/news/read/important-judgment-for-taxpayers-regarding-the-valuation-of-trading-stock>.

Chapter 8: Conclusion on the Outcome of the Research in Answering the Research Questions

This dissertation has looked into the acceptable methods for valuing trading stock in South Africa for tax purposes at the end of the fiscal year, comparing these practices with both local tax legislation and international standards. This dissertation focused on the key question (which is set out as the heading for 8.1)

8.1 How Should Taxpayers Demonstrate a Reduction in Trading Stock Value under Section 22(1) of the Act, and what is the Applicability of IAS 2 in this Context?

This section provides an overview of each chapter of this dissertation in order to summarise the outcomes and how they assist in answering the research questions:

Chapter 2: Closing Stock

The main question addressed in Chapter 2 is: What factors must South African taxpayers consider enabling them to demonstrate that the trading stock has decreased in value at the end of the fiscal year? This question explores the legislative requirements and criteria that can lead to reductions in trading stock value according to Section 22 of the Act, such as ‘damage, deterioration, change in fashion, and market value decrease’. The chapter also highlights the discretion granted to the Commissioner to determine what might be considered just and reasonable.

In conclusion, Chapter 2 underscores the distinct focus on tax valuations under Section 22 of the Act, which requires taxpayers to demonstrate a reduction in the value of trading stock based on specific past events that have occurred within the tax year. The chapter concludes by emphasising the necessity for these assessments to be evidence-based rather than speculative, thereby adhering strictly to the provisions of the Act.

Chapter 3: Commissioner's Discretion

In Chapter 3 of the dissertation, the main focus is on: How does the Commissioner determine what is just and reasonable when permitting deductions for decreases in trading stock value? This chapter looked into the historical foundation and application of the Commissioner's discretionary powers, highlighting their role in balancing fairness and accountability within the tax system.

The conclusion of this chapter emphasises the necessity for the Commissioner's discretionary powers to be exercised fairly, legally, and reasonably, while also maintaining accountability through mechanisms such as objections, appeals, and judicial reviews. It underscores the importance of a transparent and equitable application of these powers, ensuring that any discretionary decisions impacting tax liability are subject to explicit objection and appeal rights.

Chapter 4: Volkswagen Case Analysis

In Chapter 4, the main focus is on: What are the implications of using NRV for trading stock valuation for tax purposes under South African law? This chapter provides a detailed analysis of the Volkswagen case, which highlights the inappropriateness of using NRV for tax purposes under Section 22 of the Act because it contradicts the required backward-looking assessment.

The conclusion of Chapter 4 underscores that adopting NRV for valuing trading stock is inconsistent with the prescriptive framework of Section 22(1)(a) of the Act. It stresses that valuation must be based on past and verifiable events, not future projections, to ensure compliance, prevent speculative deductions, and maintain the credibility of taxable income calculations.

Chapter 5: Atlas Copco Case Analysis

In Chapter 5 of the dissertation, the main focus is on: How does the Atlas Copco case further interpret the valuation of trading stock for tax purposes under Section 22? The chapter critically examines the court's stance on the application of time-based percentage reductions by Atlas Copco, reiterating the necessity for valuation methods to be rooted in actual, historical diminutions, and aligning strictly with Section 22 requirements.

The conclusion drawn in Chapter 5 is that the Atlas Copco case underscores that the method employed in the case, which consisted of applying structured time-based reductions in stock value, was not compliant with the Act's requirements. The court determined that Atlas Copco's approach did not align with Section 22(1)(a), which necessitates evidence of actual and verifiable diminution in stock value rather than speculative predictions. The SCA ruled in favour of SARS, confirming that the valuation practices used by Atlas Copco were inappropriate for tax purposes under South African law.

Chapter 6: IAS 2 and Section 22(1) Comparison

In Chapter 6 of the dissertation, the main question addressed is: What are the differences between IAS 2 and Section 22(1) of the Act, and to what extent can IAS 2 be used to derive closing stock for the purposes of South African tax law? This chapter looked into the legislative constraints of applying IFRS standards—such as IAS 2 for tax purposes—particularly emphasising the importance of aligning Section 22 to focus on historical events instead of the anticipatory nature of IAS 2.

The conclusion of Chapter 6 highlights that Section 22 mandates a backward-looking approach, requiring that valuations are based on historical and verifiable events. This ensures compliance with tax laws and prevents speculative deductions. The chapter shows that despite Section 22(1) of the Act not sanctioning the use of IFRS, the method of valuation under IAS 2 shares a

lot of characteristics with Section 22. However, there is a fundamental difference—the forward-looking element of NRV is not present in Section 22. This stresses the need for taxpayers to adhere strictly to the Act’s requirements by basing deductions on past occurrences.

Chapter 7: International Practices

In Chapter 7 of the dissertation, the main focus is on: How do international practices in trading stock valuation compare with South African methods under Section 22? This chapter offers a comparative analysis across various countries, the UK, Brazil, Botswana, Malawi and Tanzania, examining their methods for valuing trading stock and observing how these differ from, or align with, South African practices under Section 22 of the Act.

The conclusion of Chapter 7 is that while South Africa’s trading stock valuation is more prescriptive and reliant on the discretion of the tax authorities, other countries offer more flexibility or standardisation. The chapter suggests that adopting clearer guidelines, akin to international accounting standards, could improve South Africa’s system by reducing discrepancies, thereby making compliance more efficient. It also emphasises the potential benefits of aligning tax regulations more closely with international accounting standards to provide clearer directives.

The combined summaries of each chapter’s key findings, set out here, connect them to the primary research questions addressed throughout the study, providing a comprehensive insight into the complexities of year-end trading stock valuation under South African tax law.

The research has investigated the acceptable methods for valuing trading stock in South Africa for tax purposes at the end of the fiscal year, to establish how these methods align with both international tax legislation and international accounting standards. This study focused on the key question: How should taxpayers demonstrate a reduction in trading stock value under Section 22(1) of the Act, and what is the applicability of IAS 2 in this context?

Factors for demonstrating decrease in value: It is clear from the findings that taxpayers in South Africa must base the decrease in the value of trading stock on specific past events that have occurred within the tax year, such as damage, deterioration, fashion changes, or a market value decrease. The assessment must be evidence-based rather than speculative and adhere strictly to the provisions of the Act.

What is the applicability of IAS 2 in this context?: Differences between Section 22(1) and IAS 2 Section 22(1) requires a backward-looking approach focusing on historical events that affect stock value. Although the bulk of IAS 2 looks at the same criteria, it also includes forward-looking elements such as anticipated future expenses. The South African tax framework does not permit these forward-looking elements and only mandates valuation methods aligning with actual, historical occurrences to avoid speculative deductions.

Given that South Africa is a member of BRICS, alongside Brazil which also incorporates accounting standards it may be beneficial for South Africa to consider aligning its standards with those of BRICS and other developed nations. Although South Africa is classified as a developing country such alignment is of importance.

Thus, based on the review of the approach of other countries—which indicates that other developing countries find it acceptable to allow an IAS 2-type valuation of closing stock in certain circumstances—one might ask why Section 22(1) is so rigidly applied, as confirmed by the two SCA cases.

Concluding overall, the thesis underscores the importance of precise legal guidance and the potential benefits of aligning tax policies more closely with international accounting standards to reduce discrepancies and increase efficiency and clarity in closing stock valuation. This dissertation has shown that using IAS 2 with its forward-looking elements does not align with SA tax laws but that it may be wise to do so.

8.2 Future Research

Building on the findings of this research, future studies could explore whether Section 22(1) should be altered to align with the IAS 2 standard and what the economic impact of that might be.

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List of Tables

Table 1: Abbreviations used in this document

Table 2: Definition of key terms used in this document

Table 1

Abbreviations	Meaning
IAS 2	International Accounting Standard
the Act	Income Tax Act No 58 of 1962
ITC	Income Tax Court
SCA	Supreme Court of Appeal
SARS	South African Revenue Service
NRV	Net Realisable Value
IFRS	International Financial Reporting Standards
C SARS	Commissioner of the South African Revenue Service
The Constitution	Constitution of the Republic of South Africa, 1996
BRICS Group	Brazil, Russia, India, China, and South Africa
FRS	Financial Reporting Standard
TAA	Tax Administration Act

Table 2

Key terms	Definition
Volkswagen SA (Pty) Ltd	Volkswagen
Commissioner of SARS	C SARS
Atlas Copco South Africa (Pty) Ltd	Atlas Copco

