An international comparison of the valuation of trading stock for tax purposes

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ABSTRACT

In the past few years the Supreme Court of Appeal has handed down judgments against the taxpayer with reference to the method used in determining the value of trading stock held at year end. These judgments have set the standard on the interpretation of section 22 of the Income Tax Act 58 of 1962. For a number of years, taxpayers have argued that the International Financial Reporting Standards' prescribed valuation methods should be accepted by the Commissioner as satisfactory. The contentious issue is the different interpretations that exist with regard to the valuation of trading stock at the end of the year of assessment for tax purposes in South Africa. Taxpayers in South Africa are currently experiencing some uncertainty with regard to the valuation of trading stock and the discretion which may be exercised by the Commissioner.

The objective of this study was to establish how the trading stock valuation treatment for tax purposes in South Africa currently compare with the treatment in other countries. The taxation laws regarding the acceptable method to determine the value of trading stock may differ from country to country. A literature review was conducted on the treatment of trading stock valuation in South Africa and other countries. In order to draw a meaningful comparison, the criteria and principles of a good tax system were explored and established, with reference to the valuation of trading stock, against which the South African trading stock treatment was measured.

Some areas of improvement were identified for the current South African trading stock treatment. It was established that the taxpayer needs to be equipped with the required knowledge. The South African taxpayer would have more certainty regarding the valuation of trading stock if the discretion which may be exercised by the Commissioner were better defined. This knowledge and certainty might be transferred by means of an interpretation note issued by the South African Revenue Service. Government could also consider a change in legislation in order for tax to be more closely aligned with the accounting standards as seen in countries like the United States of America. In addition, special rules for trading stock valuation for small businesses could be implemented to provide some relief to these businesses.

Key words: trading stock, inventory, valuation, cost, net realisable value, taxation policy

LIST OF ABBREVIATIONS

ACCA	Association of Certified Chartered Accountants
AICPA	American Institute of Certified Public Accountants
CITA	Canadian Income Tax Act
CRA	Canada Revenue Agency
CSARS	Commissioner of the South African Revenue Service
FIFO	first in first out
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standards
ICAEW	Institute of Chartered Accountants in England and Wales
IFRS	International Financial Reporting Standards
IN	Interpretation Note
ITA	Income Tax Act No 58 of 1962
ITC	Income Tax Court
ITEP	Institute on Taxation and Economic Policy
LIFO	Last in first out
NRV	net realisable value
NZ	New Zealand
NZIAS	New Zealand equivalent to International Accounting Standard
NZITA	New Zealand Income Tax Act
PN	Practice Note
SARS	South African Revenue Service

SATC	South African Tax Cases
SCA	Supreme Court of Appeal
UK	United Kingdom
USA/US	United States of America

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CHAPTER 1: INTRODUCTION AND BACKGROUND

1.1 INTRODUCTION

On 19 September 2018 the Supreme Court of Appeal (SCA) handed down a judgment against the taxpayer with regard to the method used in determining the value of trading stock held at year end. This ruling came after the Tax Court originally ruled in favour of the taxpayer (*CSARS v Volkswagen South Africa (Pty) Ltd*, 2018). As a result, on appeal by the South African Revenue Service (SARS), the SCA set the standard on the interpretation of the Income Tax Act 58 of 1962 (ITA). The SCA emphasised that the various accounting standards will not supersede the tax legislation (Surtees, 2018:22).

The ITA determines that a taxpayer's taxable income will be calculated by subtracting from its gross income any exempt income, as well as any deductions allowed. The taxable income will then represent the amount on which tax is levied. Where a taxpayer carries on a trade and incurs expenditure for the acquisition of trading stock, which is in the production of income and not of a capital nature, the expenditure will be deductible in determining taxable income under section 11(*a*) of the ITA. Any income generated from the sale of trading stock will be included in taxable income under the gross income definition.

A perfect correlation and true picture is reflected between income and cost of the trading stock in the event where all trading stock is purchased and sold in one year. In contrast is the taxpayer that acquires trading stock during the year, sells it at a substantial profit and acquires large quantities of trading stock just prior to the end of the year of assessment. If the taxpayer is permitted to deduct the unsold trading stock during the year it was purchased, the taxpayer would be taxed on a lesser amount. This process could be repeated every year. However, it could be argued that the taxpayer will cease trading at a point in the future, which would be the day of reckoning (*Richards Bay Iron & Titanium (Pty) Ltd & another v Commissioner for Inland Revenue*, 1996). In order to prevent the latter, section 22 of the ITA determines that any unsold trading stock at year end should be added back to gross income. Thus, the deduction for the acquisition will be deferred until the date that the goods are sold.

Financial statements are often used as a starting point in preparing income tax returns. Some adjustments to the accounting information should, however, be made in order to reflect and adhere to the taxation regulations.

The International Accounting Standards (IAS) 2 determines that the measurement for inventory held at year end shall be at the lower of cost and net realisable value (NRV) (IFRS, 2019). NRV is defined as the estimated selling price less the estimated cost of completion, as well as costs which would probably be incurred in order to sell the inventory. The cost of inventories will include all costs incurred in order to bring the inventories to their present location and condition, including purchase and conversion costs (IFRS, 2019). Similar to accounting measurement of cost, section 22(3) of the ITA provides that cost will include the cost incurred in bringing the goods to their current condition and location, and any further costs accepted under Generally Accepted Accounting Principles (GAAP) by the Commissioner.

The SCA considered the viewpoint of the taxpayer in *CSARS v Volkswagen SA (Pty) Ltd* (2018). The taxpayer applied the NRV method in accordance with IAS 2 for accounting purposes. It was assessed whether the same method of valuation could be used in determining the taxpayer's taxable income (Wright *et al.*, 2018:63).

In the most recent court case regarding the valuation of trading stock, *CSARS v Atlas Copco South Africa (Pty) Ltd* (2019), a similar issue to that of *CSARS v Volkswagen SA (Pty) Ltd* (2018) was raised. The SCA again held that the NRV method does not reflect the diminished value of trading stock at year end as contemplated in section 22 (*CSARS v Atlas Copco South Africa (Pty) Ltd*, 2019). However, in the judgment of *CSARS v Atlas Copco South Africa (Pty) Ltd* (2019), the SCA went further to suggest that section 22(1)(a) may be applied to each category of stock item, rather than to the overall stock position (Van der Zwan, 2020).

The fact that accounting and tax principles differ with regard to timing and amount has been established and dealt with in depth in the past. Although there are some similarities between the two, tax laws prevail when tax is dealt with. However, for a number of years taxpayers have argued that the International Financial Reporting Standards' (IFRS) prescribed valuation methods should be accepted by the Commissioner as satisfactory in instances where the trading stock has been valued at less than cost (Coetzee & Mosupa, 2018).

Tax legislation and policies are developed by each tax jurisdiction. In South Africa, trading stock is taxed based on section 22 of the ITA. Sources such as court cases are used in order to interpret the legislation. Because tax legislation and policies may differ from country to country, the treatment of transactions such as the valuation of closing trading stock may also differ.

1.2 PROBLEM STATEMENT AND RESEARCH QUESTION

The contentious issue at hand is the different interpretations that exist of the valuation of trading stock at the end of the year of assessment for tax purposes in South Africa. This statement is further supported by the various court cases dealing with the issue on the valuation of trading stock. Inventories pose one of the most difficult valuation problems in the calculation of national accounts and are often amongst the weakest components (Wouters & Ribarsky, 2017). Thus, the purpose of this research was to provide a better understanding of the methods that South Africa as well as other countries use to value trading stock, to identify best practices and to promote international discussions regarding the issues identified.

The question then arises: How does the trading stock valuation treatment for tax purposes in South Africa currently compare with the treatment in other countries?

1.3 Objectives

The following objectives were formulated to address the problem statement:

1.3.1 Main objective

The primary objective of the research was to analyse the South African tax treatment of the valuation of trading stock at year end. This would be achieved by conducting an international comparison of selected policies from various tax jurisdictions and by determining how South African policies compare with international policies.

1.3.2 Secondary objectives

The following secondary objectives were formulated to achieve the primary objective:

- To analyse the development of the South African taxation legislation and recent South African case law in order to determine how trading stock is taxed (addressed in Chapter 2);
- To explore the tax policies of foreign tax jurisdictions with regard to the valuation methods of closing trading stock for tax purposes (addressed in Chapter 3); and
- To analyse the guidelines set out for policy formulation and to critically evaluate the policies employed in foreign tax jurisdictions, as well as in South Africa, with regard to the valuation of closing trading stock (addressed in Chapter 4).

1.4 RESEARCH DESIGN/METHOD

Collis and Hussey (2003:2) defined research as a systematic, thorough and meticulous process of building one's knowledge through inquiry. The typical objectives of research are, amongst others, to review and scrutinise existing knowledge, to investigate an existing problem, and to provide solutions to a problem (Collis & Hussey, 2003:2).

The word "research" has a different meaning when used in different contexts (Rajasekar *et al*., 2013:2). Rajasekar *et al.* (2013:2) defined research as a logical and structured search for new and functional information on a specific research topic. Research is further described by Rajasekar *et al.* (2013:2) as a method which seeks predictions of events, correlations, theories and explanations. Research must be seen as a functional process which is performed diligently and methodically with the aim to explore theories and facts (Rajasekar *et al.*, 2013:2).

The term "research methodology" is described as the empirical study of a phenomenon by using different methods to collect dependable data (Saunders *et al.*, 2012). The word "phenomenon" can be defined as the understanding of something by deconstructing the elements which comprise the phenomenon (Terre Blanche & Durrheim, 2004). In the deconstruction of these elements, self-interpretation is applied in order to construct reality through language. In understanding the connection amongst objects and practices, a system can be developed through language (Terre Blanche & Durrheim, 2004). The phenomenon under research, for the purposes of this study, was the valuation of trading stock for tax purposes.

1.4.1 Literature review

The aim of a literature review is to obtain an understanding of existing research and debates relevant to a particular study (Western Sydney University, 2017:1). In the current study, a literature review was conducted to address the research problem. Various sources were consulted, including ITA, IFRS and the taxation legislation of selected foreign tax jurisdictions. The literature review of the selected foreign tax jurisdictions was conducted by identifying the policies they employ regarding closing trading stock. These policies were evaluated according to accepted policy setting standards. Journal articles, case law and other data sources were consulted as supplementary resources.

1.4.2 Paradigmatic assumptions and perspectives

Researchers in every field need to be aware of available research methods in order to apply the correct method in their studies (Yilmaz, 2013:1). The two major approaches in research are qualitative and quantitative research (Creswell, 2002; Mouton, 2001).

Qualitative research focuses mainly on obtaining an understanding of the research subject via a principled approach and produces non-numerical data (Punch, 1998:4). This research approach requires multiple research methods which rely to a large extent on the interpretation of information (Denzin & Lincoln, 1994:2). Qualitative research requires close researcher involvement as it seeks to understand social realities (McLeod, 2017).

Quantitative research, on the other hand, is based on numerical data and can be conducted in an objective manner (Pathak *et al.*, 2013:1). Quantitative research can be conducted to produce statistical data which is scientifically objective and, as a result, less open to conflicting interpretations (Antonius, 2003:18; Denscombe, 2010:249).

A qualitative research methodology was used in this study to obtain a better understanding of the valuation methods. It was subject to the interpretation of various sources of non-numerical data.

1.4.2.1 Ontological assumptions

Research designs are influenced by the different research methodologies (McKerchar, 2008:6). Ontology is defined as the “science or study of being” and is “concerned with the nature of essence of being or existence” (OUP, 2020). According to Glesne (2011:5), it is important to identify these philosophical and theoretical perspectives as they may influence and justify the methodology selected for conducting the research.

To gain insight into a particular phenomenon that is not generalised to a population, the interpretivist paradigm is followed (Tuli, 2010:100). This paradigm assumes that the researcher employs an open mind and a subjective stance (McKerchar, 2008:7). Therefore, the interpretivist researcher is not wholly detached from the research (McKerchar, 2008:7).

An inductive approach is followed when the research focuses on gaining in-depth understanding of the research problem and its particular circumstances (Tuli, 2010:100). In these instances a qualitative methodology is applied.

The philosophical paradigm of interpretivism was applied in this study. Investigating the various trading stock valuation methods acceptable by SARS entailed an evaluation of the clarity of legislation and whether clear limitations apply.

1.4.2.2 Epistemological assumptions

According to McKerchar (2008:6), “epistemology” can be described as the researcher’s belief regarding how knowledge is created. It is, therefore, of great importance for the researcher to understand how knowledge about the topic was created and developed. The current study focused on how the current taxation legislation was created and how it developed. Attention was also paid to the interpretation of similar sections in the respective taxation legislation and policies of other tax jurisdictions. This further contributed towards reaching the objective of the study.

1.4.2.3 Methodological assumptions

According to Howell (2013), “methodology” can be defined as the strategy followed by the researcher to undertake the research project. In this study, a critical analysis of the Income Tax legislation was conducted to gain insight into the reasoning of the legislation regarding the methods for determining the value of trading stock at the end of the year of assessment and whether the legislation provides for different situations. The analysis included a comparison of the South African legislation on valuation methods to that of foreign tax jurisdictions in order to establish different perspectives. In support of the critical analysis, legal doctrinal research was included in this study, following a customary “black letter law” approach (McKerchar, 2008:18).

Two types of policy design were identified, under which the foreign countries were grouped. The first type involves the adoption of the IFRS or GAAP in their entirety or a significant adoption thereof. The second type involves the rejection of IFRS or GAAP altogether and the prescription of tax-specific rules for valuing trading stock at year end.

The interpretation of the taxation legislation involved descriptive research. For the international comparison, comparative research was conducted, after which a conclusion was drawn.

1.5 CHAPTER OVERVIEW

Chapter 1: Introduction and background

Chapter 1 provided background to the study and stated the relevance of the research. An overview was provided on the current South African tax treatment of the valuation of trading stock at year end. The problem statement was provided, together with the research objectives and research method adopted for the study.

Chapter 2: Development of the South African taxation treatment

This chapter provides insight into the developments brought on by recent South African case law regarding the valuation methods and policies for determining the value of trading stock at year end. The developments in the legislation and explanatory memoranda applicable will be addressed.

Chapter 3: Exploring foreign tax policies

Chapter 3 explores the policies and legislation regarding the taxation treatment of the valuation of trading stock at year end of selected foreign tax jurisdictions.

Chapter 4: Analysis of the guidelines for policy formulation and critical evaluation of the policies employed

The first part of this chapter constitutes a detailed analysis of the guidelines used in formulating a tax policy. The second part comprises a critical evaluation of the policies employed by foreign tax jurisdictions and South Africa with regard to the valuation of closing trading stock. This evaluation involves a comparison of these policies with the guidelines for formulating policies, as established in the first part of Chapter 4.

Chapter 5: Summary and conclusion

The final chapter summarises the study and draws a conclusion on the research performed.

CHAPTER 2: DEVELOPMENT OF THE SOUTH AFRICAN TAXATION TREATMENT

2.1 INTRODUCTION

Trading stock, as defined in section 1 of the ITA, includes any item which is acquired or manufactured to be sold. In Chapter 1 it was mentioned that, when trading stock is purchased, it will be deductible in terms of section 11*(a)* of the ITA. However, if the trading stock is not sold at year end, section 22 of the ITA determines that the amount of the unsold trading stock should be added back and only be deducted in a subsequent year when the trading stock is sold.

Section 22(1)(*a*) of the ITA describes the amounts which should be taken into account when determining the value of trading stock for gross income purposes as:

> the cost price to such person of such trading stock, less such amount as the Commissioner may think just and reasonable as representing the amount by which the value of such trading stock, not being any financial instrument, has been diminished by reason of damage, deterioration, change of fashion, decrease in the market value or for any other reason satisfactory to the Commissioner[.]

For the SCA, the decision to be made in *CSARS v Volkswagen SA (Pty) Ltd* (2018) was whether the value of the trading stock at year end had diminished to the NRV in accordance with section 22(1) (Brink, 2018). If the value had not diminished to the NRV, the taxpayer would have had to include the value of the trading stock in gross income at an amount accepted as reasonable by SARS (Van der Zwan, 2019).

According to Surtees (2018), there are only four circumstances which can lead to diminution of trading stock below cost, namely damage, deterioration, change of fashion or decrease in market value, and other circumstances satisfactory to the Commissioner. These circumstances must have occurred in the past and have existed at year end. An element of futurity could be considered by the Commissioner should there be a certainty of an unavoidable decline in the price of the goods in the following year (*CSARS v Volkswagen South Africa (Pty) Ltd*, 2018). Any expenses in making goods marketable will not be relevant to their cost price (Surtees, 2018).

When there is an indication of a decrease in the value of trading stock at the end of the year of assessment, the acceptable practice is to compare the price at which the goods can be sold in the open market in order to confirm the decrease, according to Income Tax PN36 (SARS, 1995). The onus will be on the taxpayer to provide proof of the event that has occurred and, as a result, caused a decrease in the value of the trading stock (*Commissioner for Inland Revenue v Jacobsohn*, 1923).

Since the introduction of the ITA, numerous changes and amendments have been identified with regard to the trading stock provisions. These amendments were required due to the fluctuating dynamics of the commercial and tax treatment of trading stock, as well as the interpretations by the courts on the matter (Skotidas, 2012:1). In this chapter, earlier amendments and policy changes will be explored to gain insight into the more recent developments in the valuation of trading stock at year end, with specific reference to South African case law.

2.2 FIRST INTRODUCTION OF TRADING STOCK PROVISIONS

To grasp the full extent of amendments made to section 22 of the ITA over the years, it is important to reflect on this section when it was first introduced and before any amendments were made. The main objectives of this section, from its introduction, were to state in which circumstances and at what amount trading stock should be taken into account in determining taxable income.

Irrespective of the numerous amendments, a number of principles have remained unchanged over the years. Firstly, section 22 of the ITA is only applicable when the taxpayer is carrying on a trade for which the trading stock is used. The "carrying on of a trade" principle is also relevant for general deductions under section 11*(a)* of the ITA. Secondly, the trading stock should be held and not disposed of at year end for section 22 to be applicable. The matching principle is enforced by this section in order to ensure that the deduction for trading stock will occur only in the year the stock is disposed of. This principle is relevant for both accounting and tax purposes. Should trading stock be acquired and disposed of in the same year, the taxpayer will be entitled to a section 11*(a)* deduction. As a result, this trading stock is not taken into account for valuation purposes at year end. Thirdly, the cost of trading stock shall be the cost incurred by the taxpayer. The cost includes amounts incurred to get the trading stock in its then current condition or location. The cost price may be reduced by such amount as the Commissioner may deem just and reasonable as a result of damage, deterioration, change in fashion, decrease in the market value or any other reason satisfactory to the Commissioner.

The remainder of this chapter focuses on the main amendments made to the section over the years, with specific reference to the valuation principle. Also, a brief discussion is provided on the definition of trading stock and items which should be included in closing trading stock. The amendments are presented and discussed in chronological order.

2.3 CONDITIONS IMPOSED ON THE LAST-IN-FIRST-OUT VALUATION METHOD

In 1975 the first notable amendment to section 22(5) of the ITA was passed. Taxpayers could elect the last-in-first-out (LIFO) method of valuation for trading stock purposes at year end. By adopting this method, the taxpayer effectively increased the cost of sales and, in turn, decreased the closing trading stock, thus reducing the taxable income and tax payable (Skotidas, 2012:6).

The Explanatory Memorandum on the Income Tax Bill (The National Treasury, 1975) stipulated that a person was allowed to use the LIFO basis for valuation if satisfactory records were maintained. In addition, the Commissioner needed to be satisfied that the trading stock was accounted for on the LIFO basis for accounting purposes. Section 22(5) of the ITA was amended, which allowed the Secretary to impose conditions on a taxpayer that adopted the LIFO method of valuation.

2.4 RECOGNITION OF VALUATION METHODS ACCORDING TO GAAP

In 1983 section 22(3A) was introduced to allow taxpayers to value trading stock at year end based on GAAP. However, when the cost price as determined by section 22(3A) exceeded the cost price otherwise determined by subsection (3), the taxpayer had to notify the Commissioner of the chosen method before submitting its return. The difference between the cost price determined under section 22(3A) and subsection (3) was referred to as the "excess". Two thirds of the excess amount had to be deducted from the amount determined in subsection (1) in the first year in which the cost price was so determined. One third of the excess was deducted in the next succeeding year of assessment. At the time when section 22(3A) of the ITA was introduced, the Commissioner recognised the fact that the accounting profession had laid down some generally accepted practices for valuing trading stock. These practices also took into account various items of overhead expenses which were not taken into account in section 22(3) of the ITA. At the time, section 22(3) read:

> (3) For the purposes of this section the cost price at any date of any trading stock in relation to any person shall be the cost incurred by such person, whether in the current or any previous year of assessment in acquiring such trading stock, plus any further costs incurred by him up to and including the said date in getting such trading stock into its then existing condition or location.

The introduction of section 22*(3A)* effectively meant that a stock item may well be valued at an amount higher than what was required by section 22(3) of the ITA as described in the Explanatory Memorandum on the Income Tax Bill (The National Treasury, 1983).

The Explanatory Memorandum on the Income Tax Bill (The National Treasury, 1984) saw the scrapping of section 22*(3A),* as elaborated on above. This resulted in the expansion of section 22(3) to include the basic and fundamental principles of GAAP. Specific reference was made to Accounting Statement AC108 with regard to trading stock valuation, except for the provisions relating to the LIFO method. It was noted that the valuation of trading stock in practice was made on a number of bases which were not consistent with ITA requirements. The inconsistent treatment led to taxpayers' being treated unequally.

2.5 EXPANSION OF THE TRADING STOCK DEFINITION

The value of work in process in the construction industry was to be included in trading stock. All consumables and spare parts were also included in the trading stock definition. Prior to the inclusion of consumable stores (used in the ordinary course of trade) in the definition of trading stock, these items were not subject to section 22 of the ITA and, as a result, would not be part of closing trading stock. On the contrary, only items which formed part of the finished product would constitute trading stock in terms of section 22 of the ITA. Practice Note 6, which was applicable at the time, determined that, where such consumable stores were taken into account as consumable stores on hand at year end, the taxpayer would not be entitled to claim them as part of the opening trading stock balance in the next year of assessment. Instead, they would be written off over a three-year period on the straight line basis.

The definition of trading stock was expanded in order to include the value of consumable stores and spare parts used by the taxpayer in its trade. The three-year rule no longer applied and consumable stores held at year end would form part of the opening trading stock balance in the subsequent year of assessment. Thus, the same principles as for all other stock items also applied to consumable stores and spare parts as described in the Explanatory Memorandum on the Income Tax Bill (The National Treasury, 1990).

2.6 INCLUSION OF WORK IN PROGRESS

Before the introduction of section 22*(2A)* in 1990, construction companies were seen to be delivering a service. Consequently, none of their materials were regarded as trading stock. This led to the taxpayer's receiving a deduction under section 11*(a)* of the ITA in the year of assessment without a matching revenue stream. After the introduction of section 22*(2A)(a)*, the materials used in building, construction, engineering and similar trades were regarded as trading stock held by the taxpayer up to the date on which the contract was completed per the Explanatory Memorandum on the Income Tax Bill (The National Treasury, 1990). As a result, work in progress for such contracts needed to be taken into account when determining the value of closing trading stock in the event that the contract had not been completed at year end.

Section 22*(3A)*, which was re-introduced in 1990, elaborated on the valuation method and values to be used for work in progress at the end of the year by taxpayers carrying on a trade of construction, engineering, building or like trade. This subsection was a result of the inclusion of section 22*(2A)* per the Explanatory Memorandum on the Income Tax Bill (The National Treasury, 1990).

2.7 INTERPRETATION BY COURTS IN THE CASE OF ITC 1489

In the case of ITC 1489, the taxpayer traded as a second-hand car dealer. It recorded its closing trading stock value as 50% of the recorded cost values which, according to the taxpayer's accountants, had been company policy for many years. The taxpayer contended that its failure to attempt any determination of NRV of its trading stock by using empirical data was merely a reflection of the consistency of its fiscal policy. The taxpayer further said that the trading stock should be valued at a worst scenario or calamity basis due to the nature of the business, namely being a sole shareholder private company. However, the matter of dispute was not the valuation of trading stock but the penalty resulting from the inconsistent valuation method used by the taxpayer. To substantiate its view regarding imposing the penalty, the court held that this practice was in contravention of the valuation and disclosure method as described in ITA at the time (Income Tax Case No 1489 53 SATC 99(C), 1990). This case was one of the first to interpret the valuation principles of section 22.

The judge probed why the taxpayer had failed to attempt any determination of the NRV of trading stock by using empirical data in the years when tax returns were submitted (Income Tax Case No 1489 53 SATC 99(C), 1990). The valuation of the trading stock was also questioned, and the judge stated:

> [B]y the time the appellant's accounts came to be drawn up most of the motor cars making up the year's opening stock had been sold and it was possible to determine which had been sold at a loss. Those which were not, could be taken into account at cost and those on which losses were made could be taken in at the price realised. This left only a small number of cars in respect of which an estimate had to be made and this could be made fairly accurately on the basis of what happened to the rest. (Income Tax Case No 1489 53 SATC 99(C), 1990)

Furthermore, the judge stated, specifically with regard to the speculation in determining the NRV: "There would appear to be no reason to speculate when the march of events has made uncertain things certain. There is no need to value stock on a calamity basis, if, through the benefit of hindsight, there is no need to do so" (Income Tax Case No 1489 53 SATC 99(C), 1990).

The judgment in *Income Tax Case No 1489* did not result in an amendment to the ITA. However, the Commissioner of Inland Revenue issued PN36 in 1995 (SARS, 1995), which outlined some guidance to the taxpayer on the disclosure requirements in respect of closing stock. In cases where closing stock was valued below its cost, the guidelines indicated that the stock should be disclosed to the Commissioner, that the reasons for valuing it at a lower amount should be provided, and that the method used in valuing the stock that was written down should be disclosed (SARS, 1995). Question 5.23 of the 1995 income tax return for companies required the taxpayer to furnish a breakdown of trading stock by major categories and details on the basis of valuation, including details of any provisions, write downs or set offs against each category (Coopers & Lybrand, 1995).

2.8 FOREIGN EXCHANGE DIFFERENCES

In 1993, section 24I of the ITA was included in the Act and dealt with foreign exchange differences. It required some consequential amendments specifically related to the value of trading stock. This section was introduced with the objective of treating all gains and losses incurred in respect of foreign exchange transactions in a manner which takes into account simplicity, fairness, current tax principles, economic reality and GAAP as described in the Explanatory Memorandum on the Income Tax Bill (The National Treasury, 1993).

Section 22(3)*(a)* of the ITA was consequently amended to stop taxpayers from bringing into account exchange differences against the cost price where the cost price or any portion of it had not been realised at year end. As a result, this amendment was consistent with the provisions of section 24I.

2.9 INTRODUCTION OF AN ANTI-AVOIDANCE RULE

According to the Explanatory Memorandum on the Income Tax Bill (The National Treasury, 1994), section 22(1) of the ITA provided that the amount which should be taken into account by the taxpayer for closing trading stock was the amount of trading stock held and not disposed of at year end. It was also noted that some taxpayers did not apply the law accurately, but manipulated it. For example, taxpayers purchased trading stock and claimed the deduction under section 11*(a) or (b)* of the ITA, but did not add the value of such trading stock held and not disposed of at year end. Taxpayers contended that they had an unconditional liability to pay the purchase price and were, therefore, entitled to the deduction. It was further contended that the trading stock was not held by the taxpayer at year end for various reasons, including instances where the stock had not been manufactured by the seller or the ownership of the trading stock had not yet been transferred to the purchaser. These transactions and interpretation of the Act required the introduction of section 23F, an anti-avoidance rule, of the ITA. The result was that the deduction of trading stock purchased would be deferred until the first year of assessment where any of the following occurred:

- the taxpayer had disposed of the trading stock;

- the trading stock was included in the taxpayer's income according to section 22(1) of the ITA;
- the trading stock had been destroyed or lost and, as a result, would not be destroyed or held by the taxpayer at year end.

2.10 INTRODUCTION OF CAPITAL GAINS TAX

Capital gains tax was introduced for the first time in South Africa in 2001. The provisions of capital gains tax are contained in the Eighth Schedule of the ITA. Paragraph 12 of the Eighth Schedule provides that, when an asset becomes trading stock as defined, it should be deemed that the asset was disposed of at market value and re-acquired at the same market value.

To align with paragraph 12 of the Eighth Schedule, section 22(3) of the ITA was amended to take into account the cost as being the market value from an item being held as a capital asset to being held as trading stock, as described in the Explanatory Memorandum on the Taxation Laws Amendment Bill (The National Treasury, 2001).

2.11 MINING OPERATIONS PROVISIONS

The Taxation Laws Amendment Act No 17 of 2009 provided for the inclusion of section 15A into the Act, which came into effect in March 2010. This section was brought into the Act in order to provide for rules regarding trading stock specifically for mining operations. Section 15A determines that anything won or acquired during the course of mining operations, for example, stock piles, should be valued in terms of the South African GAAP.

Prior to the introduction of this section, there were no provisions in the ITA specifically for classification and treatment regarding mining activities. Owing to the lack of specific provisions, the taxpayer involved in mining activities had to regularly prove to SARS which items constituted trading stock and which did not (Janse van Rensburg & Van Niekerk, 2011).

2.12 DETERMINATION OF COST IN TERMS OF IFRS

It was stated in the Explanatory Memorandum on the Taxation Laws Amendment Bill (National Treasury, 2014) that IFRS, in the case of a company, should be employed in determining the cost of trading stock as per section 22(3)*(a)(i)* of the ITA. The cost includes what has been incurred by the taxpayer to acquire such trading stock including costs incurred in order to get the trading stock to its then existing condition and location, apart from exchange differences. In this way, the Commissioner's discretion in determining the cost of trading stock is removed, which was enforced by section 22(3)*(b)* of the ITA.

IAS 2.10 determines that cost should be calculated by the inclusion of costs such as taxes, transport and handling; fixed and variable overheads; and other costs in bringing the inventories to their present condition and location. However, IAS 2.16 and IAS 2.18 elaborate on costs which should not be included, for example, abnormal waste, storage costs, and administration costs which do not relate to production and selling costs.

Since the above amendments, there have been no other major amendments to the definition of trading stock in section 1 of the ITA. However, section 22 was amended to include an item-by-item valuation method, as discussed below. The past few years have also seen significant court cases dealing with the valuation of closing trading stock.

2.13 INTERPRETATION BY THE COURT OF THE APPLICATION OF THE NRV VALUATION METHOD

On 19 September 2018 the SCA ruled in favour of SARS in the case of *CSARS v Volkswagen SA (Pty) Ltd*. This ruling came after the Tax Court had earlier ruled in favour of the taxpayer (Surtees, 2018). This ruling was not just seen as a mere disagreement with the Tax Court ruling, but also as an amendment of the rules which have been applied universally for nearly 100 years (Mazansky, 2018)

Volkswagen SA (Pty) Ltd held closing trading stock which consisted of unsold vehicles for the years of assessment ending 2008 to 2010. The unsold vehicles consisted of manufactured stock, trucks and busses which had been assembled, imported vehicles, and second-hand vehicles drawn from its own fleet (Surtees, 2018).

The ruling by the SCA came a year after *Income Tax Case No 1901 80 SATC 58* between SARS and Volkswagen (Pty) Ltd which was held in the Tax Court in 2017. The Tax Court ruled that the principles as set out in the IFRS, and specifically IAS 2, were consistent with the ITA. It further concluded that the value so determined by IAS 2 represented the value of closing trading stock at the end of the year of assessment for income tax purposes. Therefore, the NRV of the taxpayer's closing trading stock, which was determined in accordance with IFRS, should have been accepted by the Commissioner in the instance where it was lower than the cost.

The SCA was tasked to consider section 22(1)*(a)* of the ITA. This section entails the general rule for closing trading stock held and not disposed of at year end, which should be included in the income of a taxpayer in determining its taxable income. As per section 22(1)*(a)* of the ITA, the taxpayer argued that it may value its closing trading stock at less than the cost. The taxpayer held that it should be able to apply this by using the NRV method in determining the value according to IAS 2. As a result, the valuation reflected that the said value of trading stock had diminished (Brink, 2018).

The real difference between the tax and accounting treatment arises when writing down inventory or trading stock. IFRS requires that inventory be carried at the lower of cost or NRV. NRV is defined in IAS 2 as “the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale”. This is in contrast to how the value should be determined in terms of section 22(1)*(a)* as seen above.

It should also be noted that the ITA grants the Commissioner discretion regarding the amount which could be deducted from the cost. In essence, there is no entitlement to this deduction in the first place. The given discretion is subject to objection and appeal by the taxpayer. Should the matter be taken to court, the court is entitled to exercise its own discretion, and its decision will supersede any discretion applied by the Commissioner (Mazansky, 2018).

The SCA provided its interpretation of the relevant provisions in section 22(1)*(a)* of the ITA with examples as follows:

> Four circumstances namely, damage, deterioration, change of fashion or decrease in market value, are specified as causing a diminution in the value of trading stock. All of those can be illustrated quite simply.
>
> …
>
> The section contemplates the possibility of there being other reasons for a diminution of value apart from the four it specifies. For that reason it empowers the Commissioner to make a just and reasonable allowance to accommodate a diminution in value of trading stock for any other reason that may be satisfactory to the Commissioner.

When determining the value of trading stock under section 22 of the ITA, the cost less a deduction for diminution should be applied. In contrast, according to IFRS, NRV is arrived at by taking into account certain future costs (after year end) including the estimated costs of completion, of making the sale, and similar costs. The interpretation by the court held that the wording of section 22 of the ITA was couched in the past tense. Thus, in the valuation of closing trading stock, only events which had already occurred at year end may be taken into account and not those anticipated in the future with which IFRS are concerned (Mazansky, 2018).

In the judgment, with reference to the submission of the taxpayer, Wallis JA held:

> There is obvious scope for an overlap between the provisions of s22(1)(a) and those of IAS 2. The former refers to a diminution of value of trading stock caused by damage, deterioration, change of fashion, or decrease in market value. Clause 28 of IAS 2, quoted above in para [35], records that the cost of inventories may not be recoverable if they have been damaged or have become obsolete in whole or part. To that extent the two correspond. But the other elements to which IAS 2 refers do not relate to the same matters

> as s22(1)(a). They are concerned with future matters such as changes in likely selling prices, or increases in the estimated costs of completion or the estimated costs of making sales.

Besides the practical difficulties, Wallis JA stated that the employment of NRV within the specific context was inconsistent with two basic principles in the ITA. First, the concept of taxation is backward looking, where that of NRV was forward looking and, as a result, incompatible. Secondly, a mismatch will occur when using NRV in this context as expenses which are expected to be incurred in future years become prematurely deductible (Brink, 2018). Allowing a future expense as a deduction is also inconsistent with the basic deduction provisions as set out in section 11*(a)* of the ITA – no actual cost was incurred during the year of assessment (Mazansky, 2018).

The court proceeded to state the following in its judgment:

> While understandable from an accounting point of view, from a taxation perspective there are problems with this approach. The fiscus is concerned with the value of trading stock as a whole. Writing down the value of part of the stock to NRV ignores the fact that the NRV of the remaining stock is higher than cost to price … Using NRV is a legitimate approach from an accounting perspective. However, I can see no reason for the Commissioner to accept that Volkswagen's trading stock had diminished in value on the basis of a calculation where Volkswagen took advantage of the "swings", where the NRV was lower than cost price, but disregarded the "roundabouts", where the reverse was true. For tax purposes the question was whether the Volkswagen's trading stock as a whole had suffered a diminution in value.

Surtees (2018) held a reservation toward the suggestion by the court that trading stock needs to be valued not on a line-by-line basis, but rather in its entirety. He further held that the current value of every item, or at least that of every category, should be considered.

Although the above case is pertinent in the valuation of trading stock at year end, subsequent court cases and amendments to section 22 of the ITA discussed below have changed this view slightly.

2.14 INTERPRETATION BY THE COURT ON THE APPLICATION OF IAS 2 FOR TAX PURPOSES

The judgment in *CSARS v Atlas Copco South Africa (Pty) Ltd* was delivered by the SCA on 27 September 2019. In delivering its judgment, the court referred back to its ruling in *CSARS v Volkswagen SA (Pty) Ltd* in 2018. Similar to the *CSARS v Volkswagen SA (Pty) Ltd* case, the central issues in the *CSARS v Atlas Copco South Africa (Pty) Ltd* case were the effects of IAS on the valuation provisions as set out in section 22 of the ITA (Surtees, 2019).

The taxpayer, a member of the Atlas Copco Group, purchased trading stock for its parent company in Sweden. The trading stock comprised machinery and equipment (spare parts and consumables included) for use in mining and related industries in South Africa. The Finance Controlling and Accounting Manual, also known as The Way We Do Things as noted by Brink (2019b), was issued by the parent company and was applied group wide. The manual states that, should trading stock be held and not disposed of in the preceding 12 months, the value of such trading stock should be written down by 50%. In the event of trading stock being held for 24 months, the value of such trading stock should be written down by 100% (*CSARS v Atlas Copco South Africa (Pty) Ltd*, 2019).

The mentioned policy was applied by the taxpayer in writing down its trading stock which was divided into six categories. This valuation was taken into account in determining its taxable income for the years of assessment ending in 2008 and 2009. SARS took the view that the policy which the taxpayer applied was not in line with the provision of section 22 of the ITA. The taxpayer was taxed accordingly. At first, the Tax Court found the reasoning of the taxpayer to be just and reasonable and ruled against the appeal of SARS. The case was heard in the SCA after the Commissioner had appealed against the ruling of the Tax Court (*CSARS v Atlas Copco South Africa (Pty) Ltd*, 2019).

Ponnan JA initially applied the five principles laid down by Leach J in *CSARS v Volkswagen SA (Pty) Ltd* (2018) to the six categories of trading stock held. He subsequently made the following general comment on the taxpayer's contentions:

> It is difficult to discern the basis on which the taxpayer contended for a diminution of the value of its trading stock. That is because its version migrated from an initial reliance on a deemed obsolescence to reliance on a group policy in accordance with IAS 2. The taxpayer did not suggest that there has been a diminution by reason of "damage, deterioration, change of fashion [or] decrease in the market value". It appears to be simply contending that because the items in question had remained on its shelves for a particular length of time, it was entitled to write down those items by fixed percentages by applying IAS 2 to determine a new NRV and create provision for obsolescence.

The ruling of the Tax Court was set aside and Ponnan JA held:

> It is apparent when the evidence relating to all six categories [of trading stock] is considered, that the taxpayer's approach essentially boiled down to this: because it held thousands of items of stock at year end, it was not feasible for it to individually value each item. For that reason, it applied its policy with reference to item descriptions. This evidence

> was accepted by the Tax Court in support of the proposition that the legislature could not have intended that a trader assess each individual item of closing stock in circumstances where they hold thousands of items of trading stock. But this was misplaced. SARS never contended that the taxpayer had to assess each individual item of stock. On the contrary, as SARS accepted, the practice of sampling in these situations is a well-recognised method of dealing with the challenges of high volume trading stock. But, that is not what the taxpayer did in this instance.

Surtees (2019) added that, by concluding this case, the SCA has confirmed twice within one year that the application of accounting standards in the valuation of trading stock, without reference to the reasons as set out in section 22(1)*(a)* of the ITA, will not be accepted in determining the value of trading stock for tax purposes. Unfortunately, the court could not, yet again, clarify the item-by-item concept which caused unease in tax circles after the judgment in *CSARS v Volkswagen SA (Pty) Ltd* (year). All the court managed to do was to refer without comment to the statement of Wallis JA.

If by "roundabouts" the judge referred to an increase in the NRV of some trading stock items carried, the increase will not be relevant for the purposes of section 22(1) of the ITA (Surtees, 2019). Section 22(1) need not be clarified in this regard – if the value of an item of trading stock fell below its cost due to accepted circumstances as contemplated in section 22(1)*(a)*, the value for tax purposes would be the lower value. Should the NRV of an item in trading stock increase above its NRV, its carrying value would be equal to cost price.

In *CSARS v Atlas Copco South Africa (Pty) Ltd* (2019) the court accepted SARS' statement that sampling is a recognised and appropriate method of dealing with high trading stock volumes. By implication, blanket valuation methods would not be acceptable. In addition, if trading stock is not high volume, an item-by-item approach should be followed (Surtees, 2019).

Brink (2019a) noted that after the initial proposed amendments to section 22 of the ITA, which stood in contrast with the above principles, the Minister of Finance tabled the revised Draft Taxation Laws Amendment Bill of 2019 on 30 October 2019. The amendments to section 22 of the ITA read:

> (1) Section 22 of the Income Tax Act, 1962, is hereby amended by the addition in subsection (1) to paragraph (a) of the following proviso:
>
> ": Provided that for the purposes of this subsection—
>
> (i) the amount of trading stock must be taken into account in determining taxable income by including such amount in gross income; and

(ii) in determining any diminution in the value of trading stock, no account must be taken of the fact that the value of some items of trading stock held and not disposed of by the taxpayer may exceed their cost price; and".

(2) Subsection (1) comes into operation on 1 January 2020 and applies in respect of years of assessment commencing on or after that date.

2.15 INTRODUCTION OF THE ITEM-BY-ITEM VALUATION METHOD

The SCA acknowledged that the NRV should be determined on an item-by-item basis to the extent it is practical (Mazansky, 2018). The court reasoned that, in this way:

> any shortfall likely to arise when the stock item is sold is identified and accounted for immediately, but no account is taken of surpluses that are likely to be realised on other stock items when they are sold. That prevents the trader from claiming profits in respect of sales that have not yet taken place. (*CSARS v Volkswagen SA (Pty) Ltd*, 2018)

As a result of the judgment in the SCA case of *CSARS v Volkswagen SA (Pty) Ltd* (2018), a proposal was made in the 2019 Draft Taxation Laws Amendment Bill regarding the way in which taxpayers may write down trading stock at the end of the year of assessment. These amendments were anticipated to have far-reaching implications for a number of taxpayers (Chong, 2019).

As mentioned previously, section 22 of the ITA grants discretion to the Commissioner with regard to the amounts allowed as deductions when trading stock has diminished. Guidance is provided in SARS' PN36 of 1995. PN36 referred to the judgment in the *Income Tax Case No 1489 53 SATC 99(C)*, amongst others (refer to 2.7 above).

Apart from the guidance and previous case law on the matter, the 2019 Draft Taxation Laws Amendment Bill proposed that any diminution in the value of trading stock should be determined on an item-by-item basis. The Draft Taxation Laws Amendment Bill (2019a) suggested that the following proviso be added to section 22(1) of the ITA:

> ": Provided that for the purposes of this subsection:
>
> (a)(i) the amount of trading stock must be taken into account in determining taxable income by including such amount in gross income; and
>
> (ii) any diminution in the value of trading stock must be determined on an item-by-item basis."

It was noted that the Explanatory Memorandum on the Draft Taxation Laws Amendment Bill (The National Treasury, 2019a) did not provide any clarification on the rationale employed for the proposed change. The Explanatory Memorandum was, in fact, totally silent on the proposal despite various anticipated issues. Various impracticalities existed, which were accepted in various court cases, in applying this proposal and were expected to have far-reaching implications for taxpayers. This proposal was also seen as a substantial policy shift given the guidance of PN36. In addition, no clarification was provided on what was meant by "item-by-item" and whether this included categories of items or every single item "down to the last nut and bolt" (Brink, 2019a).

Ultimately, this proposal was not taken up in the ITA as proposed in the Draft Taxation Laws Amendment Bill (2019b). In terms of the prescription, diminution should not be determined on an item-by-item basis. Section 22(1)*(a)(ii)* reads:

> (ii) in determining any diminution in the value of trading stock, no account must be taken of the fact that the value of some items of trading stock held and not disposed of by the taxpayer may exceed their cost price

2.16 CONCLUSION

Since the ITA was introduced, numerous changes and amendments have been identified with regard to the trading stock provisions. These amendments were necessitated due to the fluctuating dynamics of the commercial and tax treatment of trading stock, as well as the interpretations by the courts on the matter (Skotidas, 2012:1).

In 1975 the first notable amendment to section 22(5) of the ITA was passed. Taxpayers could elect the LIFO method of valuation for trading stock purposes at year end. However, this method of valuation was phased out and is no longer available under section 22 of the ITA.

In 1983 section 22(3A) was introduced and allowed taxpayers to value trading stock at year end based on GAAP. In the following year, section 22(3A) was deleted from the ITA. This resulted in section 22(3) being expanded to include the fundamental principles of GAAP. Specific reference was made to Accounting Statement AC108 with regard to trading stock valuation, except for the provisions relating to the LIFO method.

The judgment in the *Income Tax Case No 1489* did not result in an amendment to the ITA. However, the Commissioner of Inland Revenue issued PN36 in 1995 (SARS, 1995), which outlined some guidance to taxpayers on the disclosure requirements in respect of closing stock. The guidance indicated that, where stock was valued below cost, it should be disclosed to the Commissioner. Also, reasons for valuing at a lower amount should be provided and the method used in valuing the stock which was written down should be disclosed.

With the introduction of capital gains tax, and in order to align with paragraph 12 of the Eighth Schedule, section 22(3) of the ITA was amended. The cost as being the market value from an item being held as a capital asset to being held as trading stock had to be taken into account as described in the Explanatory Memorandum on the Taxation Laws Amendment Bill (The National Treasury, 2001).

It was stated in the Explanatory Memorandum on the Taxation Laws Amendment Bill (National Treasury, 2014) that IFRS, in the case of a company, should be employed in determining the cost of trading stock as per section 22(3)*(a)(i)* of the ITA. As a result, the Commissioner's discretion in determining the cost of trading stock will be removed, which was enforced by section 22(3)*(b)* of the ITA.

The monumental changes to the valuation of trading stock at year end were introduced by *CSARS v Volkswagen of South Africa* in 2018 and later by *CSARS v Atlas Copco South Africa (Pty) Ltd* in 2019. The SCA confirmed twice within only one year that the application of accounting standards in the valuation of trading stock, without reference to the reasons as set out in section 22(1)*(a)* of the ITA, is not acceptable in determining the value of trading stock for tax purposes. The SCA also emphasised that the NRV method as employed in accounting will not be acceptable for tax purposes. The NRV method takes future costs into account, which is in contravention with the tax application, which is backward looking. Unfortunately, the court could yet again not clarify the item-by-item concept in *CSARS v Atlas Copco South Africa (Pty) Ltd* (2019) which caused unease in tax circles after the judgment in *CSARS v Volkswagen SA (Pty) Ltd* (2018).

With reference to the above discussion it may be concluded that the treatment and methods of valuing trading stock for tax purposes have evolved over the past 100 years, to which both SARS and taxpayers had to adapt.

In Chapter 3 the valuation policies of other countries are explored.

CHAPTER 3: EXPLORING FOREIGN TAX POLICIES

3.1 INTRODUCTION

Chapter 2 gave a review on the developments of the South African tax policy regarding the valuation of trading stock at year end. The South African ITA has seen numerous amendments to section 22 over the past years. Section 22 states that trading stock should be valued at its cost. Cost may be determined with some reference to IFRS, but the NRV method is not acceptable to SARS. As a result, the South African tax legislation does not adopt the accounting methods as prescribed in IFRS or GAAP in their totality. Instead, tax-specific legislation regarding the valuation of trading stock is enforced. This was evident in the most recent court cases involving trading stock valuation.

In a landmark case, *CSARS v Volkswagen SA (Pty) Ltd* (2018), the SCA concluded that the language of section 22 of the ITA is couched in the past tense. Therefore, any event which causes diminution of the value of trading stock should have occurred before year end. The SCA further stated that the cost price of the trading stock, and not the anticipated market value, should be the benchmark used to determine whether diminution has occurred. If it is concluded that the value of trading stock has not diminished below cost, no adjustment will be justifiable according to section 22 of the ITA. The SCA further explained that the NRV was an entity-specific value which is determined after the cost to sell. The NRV is thus forward looking and does not represent the diminished value of trading stock as per section 22 of the ITA. In *CSARS v Atlas Copco South Africa (Pty) Ltd* (2019) the SCA again concluded that the NRV method of valuing closing trading stock is not appropriate and that, after the judgment in *CSARS v Volkswagen SA (Pty) Ltd* (2018), the Tax Court had, again, erred in its view.

This chapter explores the policies and legislation on the taxation treatment of the valuation of trading stock at year end in other countries. These policies were evaluated to gain a better understanding of other possible trading stock valuation treatments which will contribute to the critical evaluation of the policy employed in South Africa.

Inventories pose one of the most difficult valuation problems in the calculation of national accounts and are often amongst the weakest components (Wouters & Ribarsky, 2017). Thus, the purpose of this research was to provide a better understanding of the methods that countries use to value trading stock, to identify best practices and to promote international discussions regarding the issues identified.

The rules and policies with regard to valuing trading stock at year end differ amongst countries. Developed countries around the world were selected for the international comparison. Two main policy types were identified under which the countries selected for this study were grouped. In the first type, policies include the adoption of the IFRS or GAAP in their entirety or a significant adoption thereof. In the second type, the policies reject IFRS or GAAP altogether and prescribe tax-specific rules for valuing trading stock at year end. South Africa currently employs tax-specific rules and thus falls in the second group.

Group characteristic sampling was performed to select a sample for the purposes of this study (Patton, 2015). Each country was selected based on the specific information it could contribute to inform and explain the different design types identified (Patton, 2015). The United States, United Kingdom and New Zealand were selected as al employ policy design type I to a large extent. In contrast, Australia and Canada were selected based on its employment of design type II.

For purposes of the literature review, a methodical search was conducted of the tax principles and policies of other countries. This was done in order to determine which tax principles have been established through the years, as well as how international valuation policies are designed and implemented.

The sources incorporated in this study included those in which tax principles are established. Sources were also included which contained research on the trading stock valuation policy of a country, the design of the valuation policy, and the implementation of the policy. The chain-of-referral research method was followed in order to identify any other sources.

3.2 Policy design type I – Absolute or substantial adoption of IFRS or GAAP

The first policy design type assumes the absolute or substantial adoption of accounting standards in the particular country. Globally, IFRS and GAAP are mainly used for accounting purposes. However, some countries employ a variation of these standards and accounting principles. Countries which adopt this design type include the USA, the UK and New Zealand. The policies of each country are discussed below.

3.2.1 United States of America (US)

3.2.1.1 Overview

Inventory items include merchandise or stock in trade, raw materials, work in progress, finished products and supplies that become physically a part of the item intended for sale. Inventory items exclude items such as consignment goods, assets and supplies which do not physically become a part of the item intended for sale (IRS, 2019).

Methods generally available to value inventory include cost, lower of cost or market, and retail. Cost is determined using the specific identification method when the actual cost can be identified and matched to the inventory items. If the items and costs cannot be specifically identified or the same type of goods are combined in inventory and they cannot be specifically identified with their invoices, the LIFO or FIFO method may be used.

Under the lower of cost or market method, the market value of each item is compared with its cost and the lower of the two is used. This method is not available for inventory on hand or being manufactured for delivery on a firm sales contract at a fixed price, nor for goods accounted for under the LIFO method. When electing the retail method, the total retail selling price of goods on hand in each department or in each class is reduced to estimated cost by using an average mark-up percentage expressed as a percentage of the total retail selling price (IRS, 2019).

Publication 538 (01/2019), Accounting Periods and Methods published by the Internal Revenue Service (IRS, 2019), is a comprehensive guide on how inventories are to be treated in the USA. The rules for valuing inventory are not consistent for all businesses. The method a taxpayer should use must be consistent with US GAAP for similar businesses, and a clear reflection of income is required. Inventory practices should also be consistently applied from year to year (IRS, 2019).

3.2.1.2 Cost

Any of the following methods may be used to identify the cost of the inventory items, according to Publication 538 (01/2019):

- Specific identification method: Use this method when the actual cost of the inventory items can be identified and matched.
- FIFO/LIFO method: Use this method when the actual costs of the inventory items cannot be identified and when the same type of goods is combined in inventory and cannot be identified with specific invoices. (IRS, 2019)

The definition of the FIFO method under US tax law is consistent with the general meaning. However, the rules for using the LIFO method are complex. The LIFO method consists of the dollar-value method and the simplified dollar-value method. The dollar-value method prescribes that inventories be classified into one or more groups, depending on the kind of goods in the inventories. Under the simplified dollar-value method the taxpayer establishes multiple inventory pools in general categories from the appropriate government indexes. The taxpayer then uses the changes in the price index to calculate the yearly change in the price for the different pools, according to Publication 538 (01/2019) (IRS, 2019).

According to Pomerleau (2016), there were indications that lawmakers targeted the LIFO method for repeal in order to raise revenue or as a broader tax reform. This caused much controversy as critics argued that it would lead to major job losses and reduce the GDP in the long-run (Pomerleau, 2016). However, from Publication 538 (01/2019) (IRS, 2019) it can be ascertained that the LIFO method was not repealed.

In order to properly value inventory at cost, the taxpayer must include all direct and indirect costs associated with it. For inventory purchased during the year, cost will include the invoice amount minus applicable discounts plus transportation and other costs incurred in acquiring the inventory, as stated in Publication 538 (01/2019) (IRS, 2019).

3.2.1.3 Lower of cost and market method

Under this method the market value of each item in inventory is compared with its cost and the lowest is used. This method must be applied on an item-by-item basis. Therefore, the taxpayer may not value its entire inventory at cost and at market and subsequently use the lower of the two total figures. This method does not apply to the following items, which should be valued at cost:

- inventory on hand or being manufactured under a firm sales contract at a fixed price; or
- inventory accounted for under the LIFO basis (Publication 538, 01/2019 in IRS, 2019).

Market value refers to the usual bid price on the date of inventory under normal circumstances for normal goods. This price is also based on the normal quantity the taxpayer usually buys, which means that quantity discounts should not be accounted for if the taxpayer usually buys in smaller lots (IRS, 2019).

However, if the taxpayer offers the inventory at a price lower than the market price in the normal course of business, the taxpayer can value the inventory at the lower amount less the direct cost of disposition. The taxpayer must determine these prices from actual sales for a reasonable period of time. Nonetheless, prices which differ materially from the actual prices will be rejected as they will not reflect the market (IRS, 2019).

The taxpayer must use the best available evidence of a fair market price if no market exists or if there is a minimal amount of quotations due to an inactive market. This evidence may include the following:

- particular sales or purchases the taxpayer or others made in a reasonable volume and in good faith; and
- compensation paid for the cancellation of contracts for purchase commitments (IRS, 2019).

NRV is defined in ASC 330 (US GAAP, 1984) as the estimated selling price in the ordinary course of business less reasonable costs of completion, disposal and transportation. ASC 330 (US GAAP, 1984) further states that the lower of cost or NRV may be performed on an item-by-item basis, by major category, or at another level which clearly indicates income. This is mostly consistent with the valuation of inventory under the market method as discussed above.

3.2.1.4 Retail method

When applying the retail method, the total selling price of the inventory on hand at year end in each department or of each class of inventory is reduced to an estimated cost. This is achieved by using an average mark-up expressed as a percentage of the total retail selling value. The taxpayer may not use arbitrary standard percentages in order to determine mark-up. The guidance given in Publication 538 (01/2019) (IRS, 2019) should be followed to determine the average mark-up percentage. In the calculation of the retail selling price of inventory at year end, markdowns are recognised only when inventory was offered to the public at a reduced price. Markdowns not calculated based on actual data are not allowed, for example, when they are based on depreciation and obsolescence (IRS, 2019).

3.2.1.5 Exceptions – small businesses

Small businesses may elect not to keep an inventory but must still use a method of accounting for inventory which reflects income clearly. Should it elect not to keep an inventory, the taxpayer may treat inventory as non-incidental material or supplies and may also conform to the financial accounting treatment for inventories. Treating inventory as non-incidental material or supplies implies that the taxpayer will get the deduction in the year in which the inventory was purchased. Should it elect to keep an inventory, the taxpayer must use accrual accounting and value its inventory each year. A taxpayer will qualify as a small business when its average gross receipts are $25 million or less for the prior three tax years and it is not a tax shelter (IRS, 2019).

3.2.2 United Kingdom (UK)

3.2.2.1 Overview

The Business Income Manual (BIM) 33015 (HMRC, 2020b) published by the UK government describes stock of trade as anything acquired with the intention of reselling at a profit. When accounts are prepared in accordance with UK GAAP, inventory should be classified as raw materials and consumables, work in progress, finished goods and goods for resale, and payments on accounts (HMRC, 2020b). In the BIM33035 (HMRC, 2020c) it is noted that the statutory definition of trading stock is wide and that relevant case law should also be considered when evaluating whether an item will be regarded as trading stock.

Section 174(1) of the Income Tax (Trading and Other Income) Act 2005 describes the term as follows:

> In this Chapter "trading stock" means—
>
> (a) any property (whether land or other property) which is sold in the ordinary course of the trade or would be so sold if it were mature or its manufacture, preparation or construction were complete, or
>
> (b) materials used in the manufacture, preparation or construction of any property mentioned in paragraph (a).

According to BIM33100 (HMRC, 2020d), UK GAAP is a starting point for determining the stock valuation for tax purposes. It should, however, be noted that UK GAAP does not prohibit valuation methods such as LIFO which is not an allowable method for valuing stocks for tax purposes in the UK (HMRC, 2020d). The BIM33115 (HMRC, 2020e) states that only the following two methods are accepted for valuing stock and work in progress:

- the lower of cost or NRV; and
- mark to market.

None of the other valuation methods are acceptable for tax purposes. The valuation prepared in accordance with UK GAAP for financial purposes should be accepted if it reflects the correct application of UK GAAP. The method should also pay sufficient regard to the facts and the basis should not be in contravention of the interpretations by the courts (HMRC, 2020e). In the cases of *Ostime v Duple Motor Bodies Ltd [1961] 39 TC 537* and *Threlfall v Jones [1993] 66 TC 77* it was concluded that the basis of valuation adopted in accounts should be accepted for tax purposes. In the case of *Minister of National Revenue v Anaconda American Brass Co Ltd [1956] 2 WLR 31* the need for the basis of valuation to reflect the actual facts was emphasised. In the instance where a valuation is made without sufficient attention being paid to the facts, it will not be acceptable even if it is made on a recognised basis.

3.2.2.2 Lower of cost or NRV

It is stated in the BIM33135 (HMRC, 2020f) that the term "cost" should be interpreted as the total historical cost of bringing the stock item to its existing condition and location. Where the historical cost cannot be precisely determined, the closest approximate cost that is practically attainable should be used. In exceptional circumstances stock may be valued at replacement cost method value, including:

- Where the price of raw materials is liable to significant fluctuations and the value of raw materials forms a considerably high proportion of the total value of stock. In the mentioned case the replacement cost method may be extended to cover stock in process of production, finished stock and the stocks of raw materials.

- In circumstances where traders such as motor dealers who acquire stock in part exchange transactions at a price which in substance includes a discount on the new vehicle which is sold.

The BIM33140 (HMRC, 2020g) elaborates on the NRV method which may be used in the valuation of stock should it be lower than the cost as discussed above. The realisable value represents the expected sales price in a normal selling market. From this value is deducted any future costs which will be incurred in order to bring the stock to its normal selling condition and, as a result, NRV. However, the NRV should not be arrived at by valuing the stock on the basis on which it will be sold in a force sale on the reporting date in a possible incomplete state.

Stocks should generally be valued on an item-by-item basis, but UK GAAP also accepts the grouping of similar items to be considered together. In arriving at the NRV, a formula based on predetermined criteria may be applied to the cost of similar items. Such a formula normally takes into account the age and condition, demand and the scrap value of such items of stock. The formula should be reviewed and assessed for reasonability (HMRC, 2020h).

3.2.2.3 Mark to market

GAAP (FRS102) strictly allows only the use of the lower of cost or NRV method for valuing stock. Entities that wish to use the mark to market method should use the true and fair override described in the BIM31020 (HMRC, 2020a). This entails that the taxpayer assert that, in order to portray a true and fair picture of the entity, a mark to market valuation method be used, instead of the lower of cost or NRV (HMRC, 2020i).

This method may be applied only where there is a liquid market in the stock where the value could be realised easily. Financial institutions and commodity dealers currently use this method (HMRC, 2020i).

3.2.3 New Zealand (NZ)

3.2.3.1 Overview

Section EB2(1) of the Income Tax Act (NZ ITA) 2007 No 97 describes trading stock as property held by a person who carries on a business for the purpose of selling or exchanging in the ordinary course of business. Subsection (3) specifically excludes from the definition of trading stock consumables used in the process of producing trading stock and spare parts not held for sale or exchange.

Trading stock valuation rules for tax purposes are aligned in a number of ways with the accounting treatment as per the New Zealand Equivalent to International Accounting Standard (NZIAS) 2 (NZ Treasury, 2006). Trading stock is valued at the "lower of cost or market selling value" under sections EB6 and EB11 of the NZ ITA, in accordance with NZIAS 2 (NZ IFRS, 2019). In addition, discounted selling price and replacement value, as described under sections EB9 and EB10, are the other two methods available in the event where the taxpayer also uses these methods to determine the valuation of trading stock for financial statement purposes (NZ Treasury, 2006).

3.2.3.2 Cost

Per section EB6 of the NZ ITA, a taxpayer has to include and allocate all costs as per GAAP or by applying NZIAS 2 should it elect the cost method. According to NZIAS 2 (NZ IFRS, 2019), the cost of inventories includes all costs incurred in bringing the inventory to its current condition and location. Such costs include import duties and other purchase taxes not recoverable subsequently, transport and handling costs, and any other direct cost of acquisition. Moreover, deductions and discounts reduce the cost of inventories.

The taxpayer does not comply with GAAP if the value of stock is materially different when NZIAS 2 is applied (NZ IFRS, 2019). Section EB7 of the NZ ITA further explains that, when a taxpayer elects to determine the value of trading stock at cost, it must use the same cost-flow method it is using in its financial statements. The cost-flow methods of cost allocation are FIFO and the weighted average method. When it has a manufacturing business and determines closing stock value at cost, the taxpayer may use the budget method or standard cost method as per section EB8 of the NZ ITA.

3.2.3.3 Market selling value

Stock may be valued at the market selling value, as described in section EB11 of the NZ ITA, should it be less than the cost of the stock. The market selling value is arrived at by taking the normal selling price a taxpayer would usually expect to receive in the ordinary course of business and deducting the estimated cost of completion plus estimated selling costs. Expected cost of selling is the costs a taxpayer usually incurs for transport, insurance, sale commission and discounts to buyers.

3.2.3.4 Discounted selling method

As described in section EB9 of the NZ ITA, a taxpayer may determine the closing value of trading stock for tax purposes using the discounted selling method if the taxpayer uses this method for trading stock purposes in its financial statements. With regard to retailers, the discounted selling price is determined by the total of the retail selling price for each category or for each department, less the normal gross profit margin for that category or department. Retailers with an annual turnover of $1 million or less may determine the discounted selling price for all closing stock valued under this method by discounting the total retail selling prices by the average gross profit margin. Non-retailers may determine the discounted selling price for each category of goods by deducting the gross profit margin for the category of trading stock from the total market selling value.

3.2.3.5 Replacement price method

Section EB10 of the NZ ITA prescribes that a taxpayer may use the replacement price method to determine the value of closing trading stock for tax purposes if this method is also used in its financial statements. The replacement value is defined as the market value of such trading stock on the last day of the income year or, in the absence of such market value, the last price the taxpayer paid during the income year to acquire such trading stock, and it does not include an amount of input tax for the supply of the trading stock.

3.2.3.6 Special rules – low-turnover traders

Special trading stock valuation rules are available for low-turnover traders under sections EB13 to EB23 of the NZ ITA. A low-turnover trader is described as a person who carries on a business where the total turnover of the business and associated persons do not exceed $3 million and the sum as specified by the Governor-General by Order in Council. The Governor-General may make an Order in Council in order to increase the amount. Methods available for low-turnover traders are cost, discounted selling price, replacement price and market selling price for low-turnover traders as described in section EB14 of the NZ ITA. Section EB23 of the NZ ITA describes the instance where a taxpayer carries trading stock at $10 000 or less and has turnover of $1.3 million or less in an income year. If it reasonably estimates that its closing stock for the income year is less than $10 000, the taxpayer may use the opening value of trading stock as the closing value of its trading stock for the income year.

3.3 Policy design type II – tax-specific rules for the valuation of trading stock

The second policy design type assumes tax-specific rules for the valuation of inventory. Very limited reference is made to IFRS or GAAP in this design type. When reference is made to IFRS or GAAP, numerous differences and exclusions are applicable. Countries which adopt this design type include Canada, Australia and South Africa. The policies of each country will be discussed below, excluding South Africa, which was discussed in Chapter 2.

3.3.1 Canada

3.3.1.1 Overview

The term “inventory” is defined in subsection 248(1) of the Canadian Income Tax Act (CITA) as:

> a description of property the cost or value of which is relevant in computing a taxpayer’s income from a business for a taxation year or would have been so relevant if the income from the business had not been computed in accordance with the cash method and includes
>
> (a) with respect to a farming business, all of the livestock held in the course of carrying on the business, and
>
> (b) an emissions allowance; (inventaire)

Section 10 of the CITA and Part XVIII of the Income Tax Regulations set out the guidelines for valuing inventory at year end. Other methods may be available or required, but in most circumstances a business may use one of the following methods to value inventory:

- Each item in inventory may be valued at the lower of original cost to acquire or fair market value at the end of the year; or
- The entire inventory may be valued at its fair market value at the end of the year (CRA, 2020b).

3.3.1.2 Fair market value

The term “fair market value” is synonymous with the word “market” used in the accounting phrase “lower of cost or market” (CRA, 1998). The Inventory and Cost of Goods Sold guide describes fair market value as “the price you would pay to replace an item or the amount you would get if you sold an item” (CRA, 2020). The IT473R reiterates that the term generally refers to replacement cost or NRV (CRA, 1998).

Generally, when the fair market value for tax is determined, the same methods used to determine “market” for accounting purposes will be used (CRA, 1998). However, for accounting purposes the NRV refers only to the net amount the taxpayer will receive when selling the inventory. In contrast, the CITA allows for the fair market to be either the amount the taxpayer will receive when the item is sold or the amount which will be paid to acquire an item. In the event where multiple methods are available under GAAP, the method which represents the truest picture of the taxpayer’s income should be used to determine “fair market value” for tax purposes (CRA, 1998). The chosen method should be applied consistently from year to year unless a new method represents a truer picture of the taxpayer’s income (CRA, 1998).

Paragraph 10(4)(a) of the CITA determines that the fair market value of work in progress will be the amount which can reasonably be expected to become receivable after year end. Paragraph 10(4)(b) of the CITA describes further that the replacement cost should be taken into account for advertising or packaging material, parts, supplies or other property (excluding work in progress) that is included in inventory. In the event where inventory has deteriorated to such an extent that it cannot be disposed of in the normal course of business, the NRV method should be employed instead of the replacement cost method when determining the fair market value (CRA, 1998). The remainder of the inventory may still be valued using the replacement cost method (CRA, 1998). Irrespective of the method chosen to determine the fair market value, the reduction of the inventory valuation in order to accommodate for possible losses in the future is not accepted (CRA, 1998).

3.3.1.3 Cost

The term "cost" which is used in section 10 of the CITA is defined as the original cost of the item together with any additional costs to bring the item to its current condition and location (CRA, 1998). Laid-down costs should be taken into account with reference to inventories acquired for resale and for raw materials used in manufacturing. Laid-down costs include invoice costs, customs and excise duties, transport and other acquisition costs, as well as storage costs, when significant (CRA, 2018).

If it is impractical to determine the cost with reference to specific items of inventory, an arbitrary cost estimation method is used. Methods commonly used include specific item, average cost and FIFO. LIFO is not acceptable (CRA, 1998).

3.3.1.4 Valuation of manufactured inventory

With reference to work in process and finished goods, cost includes the laid-down costs of materials as well as direct labour and the allocated overhead expenses (CRA, 2018). Either direct costing or absorption costing is an acceptable method for costing inventory (CRA, 2018). The direct method allocates only variable overhead together with direct material and direct labour to the item, whilst the absorption method allocates variable as well as fixed overhead to the item (CRA, 2018).

Standard costing is also an acceptable costing method, provided that there are no significant variations between the standard costs and the actual costs (CRA, 2018). The prime cost method where no overhead is allocated to an item is not acceptable (CRA, 2018).

3.3.1.5 Retail inventory method

The retail inventory method generally yields the lower of cost or market value. According to the Income Tax Audit Manual (2018), this method is acceptable to the Canadian revenue authority only when it meets these three conditions:

1. The business has a number of different products for sale (for example, a grocery store).
2. The values of these products are established in accordance with GAAP.
3. The established values are used for both tax and financial statement purposes.

To implement the retail inventory method, a cost ratio should be determined by recording purchases during the year both at cost and at retail (selling price) (CRA, 2018). The cost ratio is determined by comparing the opening inventory at cost plus the purchases during the year at cost with the opening inventory at retail plus the purchases at retail during the same period. The estimated inventory value is then determined by applying the resultant cost ration to the book inventory value at retail, which is the price being asked at that time. If the retail inventory valuation is in accordance with GAAP and the information is also used by third parties, the CRA (2018) will not challenge the valuation.

3.3.1.6 Adventure in the nature of trade

In order to determine taxable income in Canada other methods of inventory valuation may also be used or are prescribed in certain circumstances as depicted in the Income Tax Audit Manual. When a taxpayer derives income from an adventure or a concern in the nature of trade, the inventory is valued at cost per subsection 10(1.01) of the CITA. When a person habitually engages in something which is capable of producing a profit, he or she is carrying on a business or a trade. This applies irrespective of whether these activities are separate from his or her ordinary occupation, for example, a dentist who habitually buys and sells real estate (CRA, 1980).

In contrast, when such activities are infrequent rather than habitual, it is still possible to argue that the person was involved in a business transaction as defined in subsection 248(1) of the CITA. It may be argued that the person has engaged in “an adventure or concern in the nature of trade” (CRA, 1980). Although an adventure or concern in the nature of trade is included in the definition of a “business” in section 248 of the CITA, it does not suggest that the taxpayer is “carrying on” a business or has “carried on” a business (CRA, 1980). The Courts have emphasised that all circumstances of the transaction should be taken into account when determining whether a transaction is an adventure or concern in the nature of trade (CRA, 1980). No single criterion can be formulated to decide whether an adventure or concern in the nature of trade exists (CRA, 1980). Subsection 10(1.01) of the CITA was added as a result of the judgment in *Friesen v The*

Queen (SCC) 1995 (Canada). The Supreme Court allowed the taxpayer to value a raw parcel of land in accordance with the previous subsection 10(1). This resulted in a loss realised on the property before its sale. Subsection 10(1.01) now prevents such inventory from being written down, and any loss is realised only when it is sold (CRA, 2020a).

3.3.2 Australia

3.3.2.1 Overview

As stated in the Income Tax Assessment Act (ITAA), the term "trading stock" is defined as anything a business produced, manufactured or acquired which is held for the purposes of manufacturing, sale or exchange in the ordinary course of business, as well as live stock. The Australian Taxation Office provides guidance on the items which are excluded from the definition of trading stock, namely:

- Timber, fruit or crops (standing or growing): these will fall within the definition of trading stock only when they are felled, picked or harvested;
- Spare parts held for repairs and maintenance of plant and equipment;
- Goods owned by a lending business which are used to generate income by hire or rental, rather than in the process of manufacturing, sale or exchange; and
- Consumables used in the manufacturing of trading stock (ATO, 2019a).

Taxpayers are required to conduct a stock take every year as close as possible to year end. A different method may be used each year for different items of stock. Each stock item is then valued using one of the following methods:

- Cost price method: this includes all the costs incurred into bringing the stock item into its current condition and location.
- Market selling value method: this method uses the current value of stock if it is sold in the normal course of business.
- Replacement value method: this method uses the cost to obtain an identical or almost identical item in the market on the last day of the year (ATO, 2019a).

3.3.2.2 Cost price method

The terms "cost" and "cost price" are not defined in the ITAA (ATO, 2006). Thus, for purposes of the study, commentary, case law and additional sources had to be explored in order to define these terms in an Australian context.

In the absence of the statutory definition of "cost" or "cost price", the Board of Review and the Courts have applied commercial and accounting principles in a number of cases involving the calculation of the cost of trading stock (ATO, 2006). In the case of *FC of T v St Hubert's Island Pty Ltd (in liq) 78 ATC 4104; (1978) 8 ATR 452*, Mason J stated (at 78 ATC 113; 8 ATR 462):

> as the definition of "trading stock" contained in sec. 6(1) [of the ITAA 1936] is not an exclusive definition, it requires us to give effect to the ordinary, and in this case that happens to be the commercial, meaning of the expression[.]

In *Case 19 1946 12 TBRD 128 (OS) (Australia)*, the Board of Review confirmed that an importer of petroleum products should value its trading stock by adding the direct costs incurred in having the stock items delivered to its premises to the invoice price. The Board of Review accepted the meaning of cost as generally in accounting terms, although it recognised that the cost price was possibly not susceptible of the precise definition (ATO, 2006).

In the case of *Philip Morris Ltd v FC of T 1979 79 ATC 4355; 1979 10 ATR 44*, the taxpayer employed a direct costing method to value its trading stock. The direct costing method includes only the costs relating to materials plus the wages of those employees who are directly involved in the manufacturing process (ATO, 2006). Prior to the hearing, the parties had agreed to include variable production overheads in the cost. The Court then focused on the treatment of fixed factory overheads. The Court assumed "that the legal conception of what is required, or permitted, by subsection 31(1) when a manufacturer exercises his option to value an article of trading stock at cost may be enlarged or varied by proof of relevant changes in accounting principle or practice."

The Court further held that a portion of fixed factory overheads should be included in the cost. The Court subsequently rejected the direct costing method as it produced a value for cost which was a measure of the gains for a business rather than an accurate reflection of what the item of trading stock had actually cost the taxpayer to manufacture (ATO, 2006).

The case of *FC of T v Kurts Development Limited* (1998) also dealt with the valuing of trading stock at cost price. The taxpayer bought land and subdivided the broad acres into blocks. The land was regarded as trading stock for the taxpayer. The taxpayer incurred indirect expenses for works on nearby located public land and structures not owned by the taxpayer. The indirect expenses were incurred in order to assist in the provision of the services to the taxpayer's subdivided blocks, as well as for the services rendered by the local authority in relation to the subdivision (ATO, 2006). The Full Federal Court ruled that the indirect expenses incurred had to be absorbed in determining the cost of the closing trading stock (ATO, 2006).

Even though the rulings in the Philip Morris and Kurts cases did not deal with retailers and wholesalers, they do help to clarify the valuation principles in general (ATO, 2006). The taxpayer in the Philip Morris case was a manufacturer and the issue before the court was the valuation of trading stock up to the completion of the manufacturing process. The ruling in this case indicated that it is acceptable for the trading stock of a manufacturer, who is not also a distributor, retailer or a wholesaler, to be in its final location at the completion of the manufacturing process. Therefore, costs should be absorbed until the manufacturing process is completed (ATO, 2006).

The Federal Commissioner of Taxation released a ruling on the cost method of valuing trading stock in Taxation Ruling (TR) 2006/8 (ATO, 2006). This ruling applies to taxpayers in the retail and wholesale industries who elect to value their trading stock at "cost" for the purposes of subsection 70-45(1) of the ITAA. Prior to this ruling, there was no clear position for retailers and wholesalers on the correct method in valuing trading stock (Aitken, 2007).

The main focus of TR 2006/8 is the application of the absorption costing method for retailers and wholesalers (ATO, 2006). The absorption costing principles are relevant when taxpayers use "cost" as basis for valuing trading stock (Aitken, 2007). The cost of each trading stock item includes all direct and indirect costs incurred in relation to that item in bringing that item to its present location and condition (ATO, 2006). This valuation method is commonly known as "absorption costing". Freight, insurance and other costs incurred in the normal course of business in bringing these items to their point of sale should be added to the invoice cost to determine the value under absorption costing principles (ATO, 2006).

3.3.2.3 Market selling value method

In the case of *Australasian Jam [1953] HCA 52; (1953) 88 CLR 23; 5 AITR 566; 10 ATD 217*, the taxpayer valued its trading stock at year end at standard value which the company had never recalculated from as early as 1914 up to 1947. The taxpayer's trading stock comprised jams, canned fruits and tinplate. The standard values used by the taxpayer did not accommodate the varieties under each of the different stock items. The standard values which were taken into account were for a standard box of a dozen tins of fruit, a standard box of a dozen jars of jam and a standard "base box" of tinplate.

The taxpayer's valuation method came to the attention of the Commissioner after legislation was amended in 1938, requiring taxpayers to disclose their valuation method (Smith, 2005). The Commissioner adjusted the valuation by calculating the cost of a standard box of jam by averaging the cost of producing all 20 variants of jam. The reason for this was that it appeared that the taxpayer only accounted for the total number of boxes and not per variety (Smith, 2005).

Fullagar J proceeded to consider the meaning and application of the words "market selling value":

> If one supposes such a sale – by auction or otherwise – I am quite prepared to accept the evidence that much lower values than those taken by the Commissioner would have been realised. But it is not to be supposed that the expression "market selling value" contemplates a sale on the most disadvantageous terms conceivable. It contemplates, in my opinion, a sale or sales in the ordinary course of the company's business – such sales

> as are in fact effected ... In arriving at market selling value, it is legitimate to make allowance for the fact that normal selling will take place over a period. But the supposition of a forced sale on one particular day seems to me to have no relation to business reality. (Australasian Jam, 1953)

Numerous commentators and the Board of Review found that Rowlatt J interpreted “market value” to mean “replacement cost” in the case of Brigg Neumann (Smith, 2005). With regard to “market selling value”, Fullagar J concluded that “[t]o attempt to arrive at market selling value on the supposition that the whole of the stock in hand must be offered for sale and sold on the last day of the accounting period is, in my opinion, to proceed on a wrong basis” (Australasian Jam, 1953).

This commentary recognises that the “market selling value” takes into account the actual markets in which these items can be sold, as well as the quantities expected to be sold in each market (Smith, 2005). In addition, if some items are subject to a specific contract, those items should be valued at the contract price instead of the general or normal market for selling such items (Smith, 2005).

According to Aitken (2007), the market selling value refers to the price at which trading stock would change hands between a willing seller and a willing buyer. Neither the seller nor the buyer must be under any obligation to sell or to buy, and both parties should have reasonable knowledge of the relevant facts (Aitken, 2007). It is the most probable price at which goods and services will be exchanged in a free and open market (Aitken, 2007).

3.3.2.4 Replacement value method

Tax Ruling 92/1 (ATO, 1992) explains that, in order to elect the replacement value method, substantially identical trading stock items must be available in the market. The replacement value refers to the amount a party would have to pay, at the current time, to replace any of its assets. The replacement cost is not the market value, but rather the cost to replace the asset at its pre-loss condition (Aitken, 2007).

There may be instances when the replacement value method is not an option. In the case of *Parfew Nominees Pty Ltd v FCT* (1986), the taxpayer had elected to use the replacement value method to value its trading stock which comprised strata title units. The court rejected the use of this method based on a notional calculation of constructing the same building on the same location, as the basis of the calculation did not represent business reality.

3.3.2.5 Interaction between tax and accounting

Australian tax policy and interpretation confirm that the valuation of trading stock for tax and accounting purposes may differ depending on the circumstances (ATO, 2006). The use of absorption costing, as described in Australian Accounting Standards Board (AASB) 102, would often produce an acceptable value of the cost of trading stock for tax purposes. However, some non-deductible costs, which are absorbed for accounting purposes such as the provision for holiday pay, are not relevant for the valuation of trading stock for tax purposes (ATO, 2006). Inventories may be recorded in the financial statements at “cost” or “NRV”. The ITAA does not permit the taxpayer to value its trading stock at its “NRV”. Similarly, the ITAA provides for two other valuation methods, namely market selling value and replacement value, which are not permitted under AASB 102 (ATO, 2015).

3.3.2.6 Small business provisions

The rules regarding trading stock for small businesses are simplified. A taxpayer qualifies for using these rules when its annual turnover is less than $10 million a year and estimations indicate that the change in trading stock will not exceed $5 000 in the year. Should this be true for a taxpayer, the taxpayer would not be required to conduct a formal stocktake or account for the changes in the value of trading stock. Estimates are considered reasonable when a constant level of stock is maintained each year and the taxpayer has a reasonable idea of the value of the stock or when the level of stock fluctuates but an estimate can be made based on records of stock purchased (ATO, 2020b).

Should the difference be more than $5 000, the general trading stock rules should be complied with. This also applies when the difference is $5 000 or less and the taxpayer elects to do a stocktake and account for the changes. The general trading stock rules prescribe that the taxpayer must do an end-of-year stocktake and determine the value of all stock on hand at both the beginning and the end of the income year. The closing value for the one year should usually be the opening value for the next year. However, in the event of a change in the values, the taxpayer needs to take the difference into account in its assessable income (ATO, 2020b).

3.4 CONCLUSION

This chapter explored international tax policies and legislation with regard to the valuation of closing trading stock for tax purposes at year end. The policies and legislation of five foreign, developed countries were analysed to gain insight into the methods they employ for valuing closing stock for tax purposes. Some policies adopt IFRS or GAAP in their entirety or substantially. Other policies reject IFRS or GAAP substantially and prescribe tax-specific rules for valuing trading stock at year end.

From the discussion above, it can be concluded that these foreign countries employ various policies with regard to the valuation of trading stock at year end. In some instances, the policies show similarities, but a vast number of differences can be seen in the approach across the spectrum.

It was found that the valuation of closing inventory in the USA should be in accordance with GAAP. The LIFO method is acceptable in determining these valuations. Special rules also exist in the USA for small businesses with regard to the valuation of inventory at year end.

In the UK, GAAP is viewed as a starting point from which to determine the stock valuation for tax purposes in the UK. However, the LIFO method, which is acceptable under UK GAAP, is not acceptable for tax purposes. The NRV method may be used in the valuation of stock should it be lower than the cost. Stocks should generally be valued on an item-by-item basis, but UK GAAP also accepts the grouping of similar items to be considered together.

Valuation methods used in New Zealand are cost, discounted selling price, replacement price and market selling value. In arriving at the cost, GAAP may be used, but the LIFO method is not accepted, only FIFO or weighted average. Special rules apply to small businesses in certain circumstances.

In Canada, inventory is valued on an item-by-item basis at the lower of cost or fair market value, or the entire inventory may be valued at fair market value. In some instances, using the NRV is also acceptable.

In Australia, provision is made for the valuation of each closing trading stock item to be valued at cost, market selling value or replacement value. Simplified rules are also provided for small businesses.

In the first part of the next chapter a detailed analysis of formulating a tax policy is provided. The second part comprises a critical evaluation of the different policies employed by foreign countries and South Africa with regard to the valuing of closing trading stock. The evaluation involves a comparison of the different policies with the set guidelines for formulating policies as established in the first part of the chapter.

CHAPTER 4: ANALYSIS OF THE GUIDELINES FOR POLICY FORMULATION AND CRITICAL EVALUATION OF THE DIFFERENT POLICIES EMPLOYED

4.1 INTRODUCTION

Chapter 3 discussed the different tax policies employed by foreign countries with respect to the valuation of trading stock at year end. In Chapter 4, the focus shifts towards modern tax principles identified from an analysis of past tax publications. These publications were studied to determine the most relevant principles of a good tax system in general. These principles are discussed in detail in this chapter.

Adam Smith's four principles of tax were taken as the foundation for the literature review, after which a search for supplementary principles was conducted. All the principles were then adapted in order to establish the tax principles against which the trading stock valuation treatment can be measured. The most relevant principles with regard to trading stock valuation were subsequently identified. Thereafter, the South African trading stock valuation treatment was measured against the identified principles. In the event where it was deemed questionable whether the South African tax treatment complied with the identified principles, reference was made to the foreign countries as evaluated in Chapter 3.

4.2 THE DEFINITION OF TAX PRINCIPLES

In order to determine the applicable tax principles for the trading stock valuation treatment, the term "principle" should first be defined. A principle is a "fundamental truth or proposition that serves as the foundation for a system of belief or behaviour or for a chain of reasoning" (Oxford Dictionaries, 2015:1182). Collins Dictionary (2020b) supports this definition by describing a principle as "a fundamental or general truth, the essence of something, a source or origin". For the purposes of this study, a tax principle is viewed as the basis on which the tax system is constructed. The tax principles identified in the literature review were used as the point of departure for developing a conceptual framework to evaluate the trading stock valuation treatment.

Alley and Bentley (2005:586) indicated that tax principles only serve as guidelines in designing a tax policy. Therefore, taxpayers have no enforceable right to demand that tax authorities adhere to these principles. In addition, Alley and Bentley (2005:582) mentioned that tax principles are considered to be the values underlying the tax system. These principles are embedded within the apparent purpose of tax. It is therefore critical that these tax principles are taken into account when assessing whether the tax treatment will achieve the required outcome.

The numerous tax principles which have been established over the years need to be reconstructed and adapted for modern times (Alley & Bentley, 2005:580). Du Preez (2015:9) stated that there are certain guidelines which should be considered when tax principles are reconstructed. According to Du Preez (2015:38), the starting point when tax principles are reconstructed should be the "study of the history of a phenomenon or field of knowledge, as ideas and practices can only be identified as the basis for guiding principles by analysing and understanding the history of tax policies and the practices that shaped it". For this reason, the history of tax principles need to be considered to understand their purpose, as well as the reason why they were developed.

4.3 HISTORICAL OVERVIEW OF TAX PRINCIPLES

The first known tax guidelines were developed by Confucius as early as 500 BC. He followed the guideline of taxing citizens for only what was required and not for what was wanted (Adams, 2001:17). The guideline of taxing based on need portrayed the principle of mutual respect. The four canons, or principles, of taxation were later formulated by Adam Smith (2000):

- Equity and fairness: tax contributions should be in proportion with the taxpayer's ability.
- Certainty: tax should not be arbitrary and the amount of taxes to be paid should be certain.
- Convenience: tax should be levied in a manner which is convenient to the taxpayer.
- Economy in collection: taxes should be formulated in such a way that they take out as little as possible from the pocket of the taxpayer.

Bandelj and Sowers (2010:27) argued that Adam Smith's work of 1776 was a starting point for the development of the tax system. The current study aimed to assess prevalent tax principles in order to evaluate the trading stock valuation treatment. Therefore, the four principles as identified by Smith (2000) were seen as fundamental in identifying the applicable taxes.

4.4 COMPILATION OF THE MOST PREVALENT TAX PRINCIPLES

Over the years a number of institutions and individuals have endeavoured to establish a set of tax principles. This has resulted in different perspectives on the matter. The Davis Tax Committee (2016:5) of South Africa are of the opinion that no universal theoretical framework for developing a tax system exists. In light of this statement, this study focused on the most common tax principles identified in the past in order to establish a framework against which the different tax policies could be evaluated.

To achieve this, a literature review was conducted. The chain-of-referral research method was employed in order to establish the most common tax principles. The identified principles formed the framework against which the trading stock valuation policies were evaluated. These principles will be discussed in detail.

The most recent and available material was employed to identify and expand the search of more historic tax principles. The most recent material available from a South African context is the macro analysis report published by the Davis Tax Committee (2016).

The evolution of tax has altered tax policy formulation, from a mechanical and technical exercise to a politically and ideologically challenged mechanism (Davis Tax Committee, 2016:8). There are multiple perspectives on tax, which not only add to the complexities in designing tax policies, but also imply a material variance in the attitudes of the different perspective groups (Gentry & Ladd, 1994:747). One view is that tax serves as a coercive mechanism to showcase the state's exploitative power. A contrasting view is that tax is used in a way to redistribute wealth in a manner that will encourage economic growth and social solidarity (Davis Tax Committee, 2016). The aim of the Davis Tax Committee's (2016) report was to identify modern tax principles in a South African context. The following principles were identified (Davis Tax Committee, 2016:14):

- Equity;
- Simplicity;
- Efficiency;
- Transparency and certainty; and
- Tax buoyancy.

In some cases, some of these principles must be forgone in order to achieve various objectives of a tax system even though the principles are viewed to be equally important. The objectives pursued by many tax systems around the world are as follows (Davis Tax Committee, 2016:113):

- To raise revenue in order to fund government expenditure (usually the primary objective of taxation);
- To redistribute resources in order to promote a number of objectives, including social objectives;
- To correct market failures;
- To meet some economic policy objectives by using taxes and tax incentives to support economic growth;
- To influence behavioural changes by encouraging certain actions and discouraging others; and
- To drive international competitiveness, although this is not the main driver and should not be pursued at the expense of other, more important objectives.

Lombard (2018:18) researched the most universal tax principles that have been established by prominent publications and institutions over the years. The following tax principles were included in more than 30% of the 17 publications investigated. As a result, the researcher regarded it as universal:

- Equity;
- Simplicity;
- Efficiency;
- Fairness;
- Transparency and accountability;
- Certainty; and
- Low administrative costs.

The above-mentioned principles are elaborated on below to explore the different meanings and interpretations thereof. The discussion is threefold. First, the general application of the principle is set out. Secondly, the applicability of the principle with regard to the trading stock valuation policy is discussed. Thirdly, the identified principles are applied to the South African trading stock valuation treatment, together with the treatment in other countries. Because of the interdependencies amongst the principles, some are grouped together for the purposes of the discussion.

4.4.1 Equity and fairness

In the pivotal work, *An inquiry into the nature and causes of the wealth of nations,* Smith (2000) recognized equity and fairness as one of the four canons of tax. He argued that these two principles are interdependent and therefore grouped them. The American Institute of Certified Public Accountants (AICPA, 2017:10) supports this notion by adding that equity and fairness are reached when taxpayers receive long-term benefits for their contributions. The Davis Tax Committee (2016:9) agree with these views and emphasise that taxpayers' perception of the fairness of a tax depend on whether it is equitable or not.

Equity is defined in a number of ways. Conservatively, equity refers to a progressive tax system (Salls, 2007). A progressive tax system provides that a taxpayer with greater wealth bears a greater tax burden than the taxpayer with little to no wealth (Stewart *et al.*, 2015:7). The tax burden refers not only to the monetary effect, but also to the cost of compliance and the taxpayer's exposure to the complexities of a tax system (Henry Review, 2009:21). O'Brien (1982) noted that it is difficult to achieve equity without increasing the level of complexity in a tax system. In contrast, an unreasonably complex tax system may disadvantage a group of taxpayers who are unaware of their rights, which could, in turn, distort the equity principle (O'Brien, 1982). Achieving equity clearly requires a complex balance.

Equity and fairness can further be subdivided into two principles, namely the benefit principle and the ability-to-pay principle. These principles may be employed by tax policy designers with the aim to achieve or to maintain the complex balance (Smith, 2000). Therefore, if a tax system complies with either, it will be regarded as equitable and fair.

The benefit principle implies that a taxpayer is taxed on the benefits received from government (Abbasian & Myles, 2006:1). This principle assumes that a tax serves the same purpose as a price in a private transaction (Abbasian & Miles, 2006:1). A tax system which is developed in accordance with the benefit principle is appropriate only when the benefits and individual recipients of government expenditure can easily be identified (ITEP, 2015:3). Therefore, the benefit principle is suitable only when government does not intend to distribute wealth and income in an adapted manner. This implies that income from a specific source should be used to fund expenditure relating to only that purpose (Bird, 1976:257).

The most apparent issue with the benefit principle is that it may become regressive and, as a result, lead to a heavy tax burden on the poor (ITEP, 2015:3). This is because the principle does not take into account the income of the taxpayer, but taxes all taxpayers equally for the same benefit. Moreover, the benefit principle seems impractical to be executed in the modern-day world; therefore, the ability-to-pay principle might be more feasible (Asprey & Parsons, 1975:13).

Asprey and Parsons (1975:15), as well as Adam (2011:176), measured equity and fairness with reference to the ability-to-pay principle. It was contended by the aforementioned authors that this principle is more practical to apply than the benefit principle. In the Davis Tax Committee's (2016:9) description of this principle, tax is seen as a sacrifice for which no direct service is received. In addition, the acceptable tax burden is determined based on the taxpayer's wealth (Davis Tax Committee, 2016:9).

A taxpayer's wealth must be determined as a measurement of the taxpayer's economic wellbeing in monetary terms (Asprey & Parsons, 1975:14). As a result, if the ability-to-pay principle is applied, the financial records of all taxpayers must be readily available to ensure successful implementation of this approach and, therefore, compliancy to the equity and fairness principle.

The ability-to-pay principle can further be observed from two perspectives, namely horizontal and vertical equity. Horizontal equity refers to instances where various taxpayers who find themselves in like situations should pay similar taxes (ITEP, 2015:4). In contrast, vertical equity refers to where persons are taxed in accordance with their income, which is perceived as fair (ITEP, 2015:4).

It may be concluded from the research that the equity and fairness principle is adhered to when taxpayers are taxed in accordance with their ability to pay. This would constitute a progressive tax system where the burden increases in line with the increase in taxpayers' wealth.

4.4.2 Simplicity and certainty

Smith's (2000) certainty principle is emphasised by Asprey and Parsons (1975:15), Stewart *et al.* (2009:17) and Adam (2011:601). The certainty principle is closely linked with the simplicity principle. The Institute of Chartered Accountants in England and Wales (ICAEW, 1999:6) stated that, the simpler the tax system, the more likely the taxpayer will be certain of the amount of tax to pay, as well as how to pay. It is suggested that revenue collection by tax authorities can be improved when a tax system is simple, because simplicity enhances taxpayers' certainty of what to pay (Alley & Bentley, 2005:597).

However, it is recognised that tax rules will be complex since they should be structured in accordance with tax principles (ICAEW, 1999:6). The simplicity of a tax system might be lost in order to ensure that all taxpayers are treated fairly (Association of Certified Chartered Accountants [ACCA], 2009a:4). Even so, adherence to the principle of simplicity is not likely, due to the host of requirements which must be met by a tax system (Lombard, 2018:27). Instead, governments should aim to empower taxpayers with the relevant knowledge, which would, in turn, increase certainty on the working of tax. This will occur as a result of the link found between knowledge and certainty (Gartmeier *et al.,* 2008:101). When governments are able to establish that taxpayers have the required knowledge about the tax system, the administration of the tax system should be inspected to ensure the simplicity thereof.

Other factors which may have an effect on the simplicity of the administrative aspects of a tax system include usability and clarity of data, and whether a taxpayer must self-assess its tax (ACCA, 2009b:6). In the event where taxpayers must file a self-assessment, the language and guidance should be uncomplicated as most taxpayers do not have extensive knowledge of the tax system (ACCA, 2009b:6). Taxpayers' perception of the simplicity of a tax system will thus be influenced by the structure and comprehensibility thereof.

It is highly unlikely that the simplicity principle will be met in the modern day. Governments should, however, aim to simplify the administration and payment process. This will also have a positive impact on the certainty principle. The certainty principle should further be promoted by the transfer of knowledge to taxpayers.

4.4.3 Efficiency and low administrative costs

Collins Dictionary (2020a) describes "efficiency" as the ability to complete a task successfully without wasting energy or time. This description of efficiency mainly refers to administrative efficiency. By minimising administration costs and reaching economy in the collection of taxes, the wastage of resources is restricted (Henry Review, 2009:10). For this reason, the low administration cost principle is regarded to be part of the efficiency principle.

It was suggested that the administration costs of a tax system should be kept to a minimum by utilising technology effectively (Shahroodi, 2010:42). The personnel of tax authorities should be well equipped in order to provide a quality service to taxpayers (Shahroodi, 2010:44).

Slemrod and Yitzhaki (1996:175) argued that it is easier to tax larger companies than smaller companies because larger companies tend to keep better documentation. Since larger companies usually have good record keeping systems, it is easier to confirm that all due taxes have been collected from them (Slemrod & Yitzhaki, 1996:176). Nevertheless, the efficient collection of taxes also relies on the willingness of the taxpayer to pay. In order to increase taxpayers' willingness to pay, taxpayers should have an understanding of why they are being taxed and how the tax revenue being raised will be utilised (Davis Tax Committee, 2016:14). A tax system will be efficient in the collection of taxes only when the taxpayers view it as a good system and if it delivers quality public services (Shahroodi, 2010:43).

Policy design is another factor which impacts the efficiency principle (Henry Review, 2009:16). A tax policy has an impact on the tax gap. The tax gap is described as the difference between the taxes due by the taxpayer and taxes paid willingly (AICPA, 2017:13). Therefore, tax systems should be designed in such a way that the tax gap is minimised, which implies that non-compliance and tax evasion are minimised (AICPA, 2017:13).

4.4.4 Economic efficiency

The Davis Tax Committee (2016:84) emphasised that efficiency will be reached when tax is aligned with economic activity, in other words when tax is not limiting economic activity. The tax system must be tax neutral by producing sufficient income, with minimal impact on the economy (Davis Tax Committee, 2016:3). This description of efficiency refers mainly to economic efficiency which should be distinguished from administrative efficiency. The efficiency principle should therefore be discussed from both perspectives, namely administrative and economic.

4.4.5 Transparency and accountability

The transparency of a good tax system relies on numerous factors. One of these factors include the method employed with regards to tax collection (Davis Tax Committee, 2016:14). Taxes should be collected in a transparent manner, which implies that tax legislation in its entirety must be transparent and applied consistently (Davis Tax Committee, 2016:14). Tax policies should be transparent and should not be discriminative against any taxpayer without proper reason (ACCA, 2009b:5). The transparency and accountability principles should be grouped, as a transparent process ensures that all parties involved can be held accountable (AICPA, 2017;10).

When the processes of policy setting and approval are accessible and available to taxpayers, accountability is promoted (Lombard, 2018:33). The Davis Tax Committee (2016:9) stated that the willingness of taxpayers to pay taxes would improve when the approval process of policies is transparent. Also, the accountability and transparency of a tax system promote respect and understanding for a tax system (AICPA, 2017:10).

Transparency is usually exercised in the initial stages of the implementation of a new tax system; however, the consultation process involving various parties is often neglected (Lombard, 2018:33). ACCA (2009b:5) mentioned that the consultation process is often futile, as in most cases the policies are decided on beforehand and the consultation process is held for appearance's sake. A well-documented audit trail between all relevant parties should be kept in order to ensure that the consultation process serves its objectives (ACCA, 2009b:5). Therefore, transparency and accountability will be achieved when authorities enforce and follow a formal process of consultation when implementing or amending tax policies.

4.5 IDENTIFICATION OF THE MOST PREVALENT TAX PRINCIPLES WITH REGARD TO THE VALUATION OF TRADING STOCK

In the preceding part of this chapter the most prevalent tax principles applicable to a tax system in general were discussed. Because this study focused only on the valuation of trading stock for tax purposes at year end, the tax principles which mostly related to the research were included. A two-step approach was followed. First, the South African treatment was evaluated against the relevant principle. Secondly, where the South African treatment did not prove to be adequate, the treatment in foreign countries was discussed as possible solutions for the South African treatment.

The applicability of the most prevalent tax principles with specific reference to the trading stock valuation policy is discussed below.

4.5.1 Equity and fairness

It was concluded in 4.4.1 that the equity and fairness principle is adhered to when taxpayers are taxed in accordance with their ability to pay. This constitutes a progressive tax system where the burden increases in line with the increase in the taxpayer's wealth. Special rules may be incorporated in tax legislation in order to accommodate small businesses with reference to the ability-to-pay principle. Moreover, the tax burden refers to the cost of compliance with tax policies as well as the complexity thereof.

Owing to the fact that trading stock valuation treatment is, in general, more complex and may result in a higher cost of compliance, the equity and fairness principle will be considered when assessing the design of the policies.

4.5.2 Simplicity and certainty

To meet the simplicity and certainty principle with regard to the trading stock valuation treatment, government should ensure that the affected taxpayers are equipped with the required knowledge. Government can achieve this by ensuring that the relevant Act is clear on the topic or that detailed interpretation notes exist to guide the taxpayers in the valuation exercise. This will ensure that taxpayers are certain of the tax liability relating to trading stock, as well as how the valuations will be administered.

As mentioned earlier, the simplicity principle is not easily attainable. From previous chapters, it can be concluded that all the countries involved in the study have complex rules regarding trading stock valuation, irrespective of whether the policy is aligned with accounting principles or not.

Thus, the simplicity and certainty principle is applicable when the trading stock valuation treatment is evaluated. When this principle is met, the assumption is that the necessary knowledge regarding the different valuation treatment options has been transferred to the taxpayers appropriately and clearly.

4.5.3 Efficiency and low administrative costs

From an administration perspective, the trading stock valuation treatment may lead to increased costs. This is a result of the fact that different trading stock items can be valued in various ways, which should be reported to the authorities. In the event that the authorities do not deem the accounting standard as an acceptable valuation method, a separate set of accounts should be maintained for tax purposes. In some instances, the valuation policies may leave space for manipulation by the taxpayer. This occurs mostly when trading stock is seen to be diminished and valued at a written down amount. As a result, audits on these valuations will increase administrative costs and influence how efficiently the taxes will be collected. This notion is supported by the number of court cases regarding the valuation of trading stock.

Administrative efficiency and low administration cost were considered in evaluating the trading stock valuation treatment.

4.5.4 Economic efficiency

Trading stock is taxed as part of the taxable income of a taxpayer. Thus, the valuation of trading stock will have an impact on the amount of income tax payable. As mentioned in 4.4.4, economic efficiency is achieved when tax is aligned with economic activity and does not limit economic activity. When efficiency with specific reference to economic activity is considered, a need may arise to align the tax treatment with the economic position of the taxpayer. This might mean that losses suffered on trading stock should be treated accordingly even if they have not realised yet. It could also mean that special rules should be introduced for small businesses. Economic efficiency was regarded as a relevant principle for the purposes of evaluating the trading stock valuation treatment.

4.5.5 Transparency and accountability

Transparency and accountability are achieved when authorities enforce and follow a formal process of consultation when implementing or amending tax policies. The primary focus of this principle is on the policy formulation and implementation process. However, this study did not focus on this process, but rather on what has been implemented and what is enforced by legislation. Therefore, this principle was not explored for the purposes of this study.

4.6 APPLICATION OF THE MOST PREVALENT TAX PRINCIPLES WITH REGARD TO THE VALUATION OF TRADING STOCK

In 4.5 the most prevalent tax principles with regard to the valuation of trading stock were discussed. In this part of the chapter, the efficiency and low administration cost principle will be discussed in combination with the first two identified principles, as some connection exists. These principles were applied to evaluate the South African trading stock valuation treatment. In the event where the treatment was not adequate or clear on the respective matters, the treatment in the other countries was discussed in an attempt to find a possible solution for the South African treatment.

4.6.1 Equity and fairness

The evaluation of the equity and fairness principle in this study focused primarily on the cost of compliance. As mentioned previously, the SCA confirmed twice within one year that applying accounting standards in the valuation of trading stock, without reference to the reasons as set out in section 22(1)*(a)* of the ITA, is not aligned with the wording of section 22 with regard to determining the value of trading stock for tax purposes. The SCA also emphasised that the NRV method as employed in accounting is not aligned with the wording of section 22 for tax purposes. This places a greater burden on the South African taxpayer when valuing inventory for tax purposes which is not aligned with accounting standards. This burden is caused by the requirement to keep separate records for tax and accounting purposes, resulting in a higher cost of compliance compared with the countries in which the accounting standards are accepted.

The South African trading stock valuation treatment with regard to equity and fairness may be regarded as inadequate. The following practices from some of the countries included in the study were regarded to be more aligned with these principles. Consideration of these practices might contribute towards a possible solution for the current South African position.

The USA falls within the first policy design type, which assumes an absolute or substantial adoption of the accounting standards. The method a taxpayer should use must be consistent with US GAAP for similar businesses, and a clear reflection of income is required (IRS, 2019). Inventory practices should also be consistently applied from year to year (IRS, 2019). Thus, the cost of compliance is minimised as the taxpayer will use a valuation method uniform to the method used for financial statement purposes.

The UK tax authority prescribes that, when accounts are prepared in accordance with UK GAAP, inventory should be classified as raw materials and consumables, work in progress, finished goods and goods for resale, and payments on accounts (HMRC, 2020b). According to the BIM33100 (HMRC, 2020d), UK GAAP should be a starting point from which to determine the stock valuation for tax purposes (HMRC, 2020d). It should, however, be noted that UK GAAP does not prohibit valuation methods such as LIFO, which is not an allowable method for valuing stocks for tax purposes in the UK (HMRC, 2020d). The valuation prepared in accordance with UK GAAP for financial purposes should be accepted if it reflects the correct application of UK GAAP. The method should also pay sufficient regard to the facts, and the basis should not be in contravention of the interpretations by the courts (HMRC, 2020d). In the cases of *Ostime v Duple Motor Bodies Ltd 1961 39 TC 537* and *Threlfall v Jones 1993 66 TC 77* it was concluded that the basis of valuation adopted in accounts should be accepted for tax purposes. In the case of *Minister of National Revenue v Anaconda American Brass Co Ltd, [1956] 2 WLR 31* the need for the basis of valuation to reflect the actual facts was emphasised. In the instance where a valuation is made without sufficient attention to the facts, the valuation will not be acceptable even if it is made on a recognised basis. Thus, cost of compliance will be minimised.

Trading stock valuation rules for tax purposes are aligned in a number of ways with the accounting treatment as per the NZIAS 2 (NZ Treasury, 2006). Trading stock is valued at the "lower of cost or market selling value" under sections EB6 and EB11 of the NZ ITA, in accordance with NZIAS 2. In addition, discounted selling price and replacement value, as described under sections EB9 and EB10, are the other two methods available for the taxpayer who also uses these methods to determine the valuation of trading stock for financial statement purposes (NZ Treasury, 2006). Thus, alignment with the accounting standards will have a positive impact on the cost of compliance for the NZ taxpayer.

Together with South Africa, Canada and Australia fall under the second design type. From the research presented in Chapter 3, it may be concluded that the latter two countries have complex tax-specific rules for determining the valuation of trading stock. In the event where tax-specific rules are introduced the equity and fairness principle becomes more difficult to attain with specific reference to the cost of compliance.

The administrative efficiency and low administration cost principles should be easier to attain when policy design type 1 – the absolute or substantial adoption of IFRS or GAAP – is followed. This is due to the fact that more options to value its trading stock are available to the taxpayer.

In light of the above, a few possible solutions seem to exist for enhancing the equity and fairness principle for the South African trading stock treatment. One solution might be to employ a treatment for tax which is more aligned with accepted accounting standards. Another solution could be to assist taxpayers to correctly adjust their accounting data to be acceptable for tax purposes. However, the latter could place a greater burden on SARS and necessitate more resources to assist taxpayers in this regard.

4.6.2 Simplicity and certainty

To ensure that the simplicity and certainty principle is met with regard to the trading stock valuation treatment, government should see to it that the taxpayers involved are equipped with the required knowledge. To achieve this, government must ensure that the relevant Act is clear on the topic or that detailed interpretation notes exist which will guide the taxpayers in the valuation exercise. In this way, taxpayers would have certainty on the tax liability relating to trading stock, as well as how the valuations will be administered.

Section 22(1) of the ITA describes the amounts which should be taken into account when determining the value of trading stock for gross income purposes as:

> the cost price to such person of such trading stock, less such amount as the **Commissioner may think just and reasonable** as representing the amount by which the value of such trading stock, not being any financial instrument, has been diminished by reason of damage, deterioration, change of fashion, decrease in the market value or for any other reason **satisfactory to the Commissioner**[.] (own emphasis)

From the above extract of the ITA it can be concluded that the valuation of trading stock should be reasonable to the Commissioner. This creates a great deal of uncertainty, as it is not stipulated what precisely the Commissioner will deem to be reasonable. This notion is supported by the numerous recent court cases and amendment bills as referred to in Chapter 2.

The Explanatory Memorandum on the Taxation Laws Amendment Bill (National Treasury, 2014) stated that IFRS, in the case of a company, should be employed in determining the cost of trading stock as per section 22(3)*(a)(i)* of the ITA. In this way, the Commissioner's discretion in determining the cost of trading stock was removed. The removal was enforced by section 22(3)*(b)* of the ITA. However, section 22(3)*(b)* was later removed by section 32(b) of Act No 43 of 2014.

Thus, the South African trading stock valuation treatment does not yet meet the simplicity and certainty principle. However, from the research on the other countries it can be concluded that their policies are clear and understandable. No uncertainty is created in the other countries as in South Africa where the Commissioner is granted the power to conclude whether a valuation is reasonable or not.

The South African trading stock valuation treatment with regard to simplicity and certainty may be regarded as inadequate. The following practices from some of the other countries included in the study were regarded to be more aligned with these principles. Consideration of these practices might contribute towards a possible solution for the current South African position.

Publication 538 (01/2019), Accounting Periods and Methods published by the IRS, is a comprehensive guide on how inventories are to be treated in the USA (IRS, 2019). The rules for valuing inventory are not consistent for all businesses. The method a taxpayer should use must be consistent with US GAAP for similar businesses, and a clear reflection of income is required. Inventory practices should also be consistently applied from year to year (IRS, 2019).

According to the BIM33100 (HMRC, 2020d), UK GAAP should be a starting point from which to determine the stock valuation for tax purposes. However, it should be noted that UK GAAP does not prohibit valuation methods such as LIFO, which is not an allowable method for valuing stocks for tax purposes in the UK (HMRC, 2020d). The BIM33115 (HMRC, 2020e) indicates that there are only two acceptable methods to value stock and work in progress.

Trading stock valuation rules for tax purposes in New Zealand are aligned in a number of ways with the accounting treatment as per the NZIAS 2 (NZ Treasury, 2006). Trading stock is valued at the "lower of cost or market selling value" under sections EB6 and EB11 of the NZ ITA, in accordance with NZIAS 2. In addition, discounted selling price and replacement value, as described under sections EB9 and EB10, are the other two methods available for the taxpayer who also uses these methods to determine the valuation of trading stock for financial statement purposes (NZ Treasury, 2006).

Section 10 of the CITA and Part XVIII of the Income Tax Regulations set out the guidelines for valuing inventory at year end in Canada. Other methods may be available or required but, in most circumstances, a business may use one of the following methods to value inventory. First, each item in inventory may be valued at the lower of original cost to acquire or fair market value at the end of the year. Secondly, the entire inventory may be valued at its fair market value at the end of the year (CRA, 2020a).

From the above, it is evident that possible solutions do exist to enhance the simplicity and certainty principle for the South African trading stock treatment. Also, the discretion employed by the Commissioner could be defined more clearly in order to achieve better simplicity and certainty. SARS may also consider releasing an interpretation note on the valuation of trading stock. This should enhance the simplicity and certainty principle in the South African tax sphere with regard to the valuation of trading stock.

4.6.3 Economic efficiency

The literature review in Chapter 3 described special valuation rules for small businesses in some of the countries included in the study. Small businesses are defined differently in each country. Although these special rules or concessions to smaller businesses specifically promote the ability-to-pay principle, which falls under the broader fairness and equity principle, they also promote economic efficiency.

The research showed that, when the treatment is more closely aligned with the accounting standards, write downs are more easily recognised. This, in turn, aligns the treatment more closely with economic activity, creating greater economic efficiency. In this instance the taxpayer’s accounting records can be used by the revenue authority to verify the valuation for tax purposes.

The South African trading stock valuation treatment with regard to economic efficiency may be regarded as inadequate. The following practices from some of the other countries included in the study were regarded to be more aligned with these principles. Consideration of these principles might contribute towards a possible solution for the current South African position.

In the USA, small businesses may elect not to keep an inventory but must still use a method of accounting for inventory which reflects income clearly. Should it elect not to keep an inventory, the taxpayer may treat inventory as non-incidental material or supplies and may also conform to the financial accounting treatment for inventories. Treating inventory as non-incidental material or supplies implies that the taxpayer will get the deduction in the year in which the inventory is purchased.

In NZ special trading stock valuation rules are available for low-turnover traders under sections EB13 to EB23 of the NZ ITA. Methods available for low-turnover traders are cost, discounted selling price, replacement price and market selling price for low-turnover traders, as described in section EB14 of the NZ ITA. When the taxpayer reasonably estimates that its closing stock for the income year is less than $10 000, it may use the opening value of trading stock as the closing value of trading stock for the income year.

The rules regarding trading stock for small businesses in Australia have been simplified. Should it qualify as a small business, the taxpayer will not be required to conduct a formal stocktake or account for the changes in the value of trading stock. Estimates will be considered reasonable when a constant level of stock is maintained each year and the taxpayer has a reasonable idea of the value of the stock, or when the level of stock fluctuates but an estimate can be made based on records of stock purchased (ATO, 2020b).

From the above, there seem to be possible solutions for enhancing the economic efficiency principle for the South African trading stock treatment. A closer alignment with accounting standards will lead to easier write down of losses suffered when trading stock is still on hand. In addition, special rules for trading stock valuation for small businesses may be implemented in order to provide some relief to these businesses.

4.7 CONCLUSION

In this chapter it was established that the tax principles of equity, simplicity, efficiency, fairness, transparency and accountability, and certainty and low administration costs are the most universal. Overlapping and similar tax principles were grouped in order to establish modern tax principles. The applicability of these principles on the valuation of trading stock was evaluated and discussed.

For the purposes of this study, the equity and fairness principle refers to the cost of compliance, as well as the complexity of the policy. Simplicity and certainty are reached when the taxpayer is equipped with the necessary knowledge regarding relevant policies. The administrative efficiency and low administration cost principle is attainable when resources are not wasted, and the tax gap is narrowed. Economic efficiency is achieved when tax is aligned with economic activity and not limiting economic activity. Transparency and accountability refer mainly to the policy setting process and the extent to which taxpayers are involved in the process.

The most prevalent tax principles with regard to the valuation of trading stock were identified, namely, equity and fairness, simplicity and certainty, together with efficiency and low administrative costs, and economic efficiency.

From the discussions above, there seems to be room for improvement in the South African tax treatment. In this regard, some of the practices employed in the other countries could serve as valuable guidelines, together with the identified principles.

Based on the research conducted, the main solution for the South African treatment may be for SARS to issue an interpretation note. An interpretation note will provide more clarity for the taxpayer on what is accepted by the Commissioner. Special consideration should be given in the interpretation note to how the Commissioner will apply its discretion.

A more drastic approach will be to change the legislation altogether in order to align the tax and accounting principles, which will contribute to the attainment of the equity and fairness principle. Equity, fairness and economic efficiency may further be promoted by introducing special valuation rules for small businesses. This will provide some relief for these businesses and will likely improve economic efficiency.

In Chapter 5 the findings of the study are discussed.

CHAPTER 5: SUMMARY AND CONCLUSION

5.1 INTRODUCTION

Recent court cases in South Africa on the valuation of trading stock at year end have resulted in major uncertainty regarding the interpretation of the law. Taxpayers need clear guidance on the implementation of the tax treatment of trading stock. In addition, taxpayers are entitled to information in order to adhere to the law. In the event that a tax policy is not regarded to be a good policy, the policy will likely fail in the long term. It was therefore imperative to determine whether the trading stock valuation treatment in South Africa is seen as good tax treatment according to the identified principles.

5.2 REACHING THE OBJECTIVES OF THE STUDY

The primary objective of the research was to analyse the South African tax treatment of the valuation of trading stock at year end. The main objective of this study was supported by secondary objectives, which were addressed in the respective chapters.

5.2.1 How did the trading stock valuation treatment develop over recent years in South Africa?

It was concluded in Chapter 2 that, since its inception, the ITA has seen various changes and amendments with specific regard to the trading stock valuation treatment. These changes were necessitated by the changing commercial landscape, as well as by the manner in which the courts interpreted the legislation (Skotidas, 2012:1).

The ITA provided alignment with GAAP for a very brief period in 1983. The law was subsequently changed to include only the fundamental and basic principles of GAAP with very specific treatment for tax purposes.

Practice Note 36 was issued in 1995 (SARS, 1995) and gave some guidance to taxpayers. It also addressed the disclosure requirements in the event where trading stock was to be valued below cost.

The monumental changes to the valuation of trading stock at year end were introduced by *CSARS v Volkswagen of South Africa* in 2018 and later by *CSARS v Atlas Copco South Africa (Pty) Ltd* in 2019. The SCA confirmed twice within only one year that applying accounting standards in the valuation of trading stock, without reference to the reasons as set out in section 22(1)*(a)* of the ITA, is not accepted in determining the value of trading stock for tax purposes. The SCA also emphasised that the NRV method as employed in accounting is not acceptable for tax purposes.

The NRV method takes future costs into account, which is in contravention with the tax application that is backward looking.

Currently, a great deal of uncertainty exists due to the fact that the Commissioner may use its discretion when determining whether a valuation is acceptable. Clearly, taxpayers do not have enough guidance on what the Commissioner considers as acceptable.

5.2.2 How is the valuation of trading stock treated in other tax jurisdictions?

Chapter 3 explored the treatment and legislation with regard to the valuation of closing trading stock for tax purposes at year end of other tax jurisdictions. The treatment and legislation of five foreign, developed countries were analysed to gain insight into the methods for valuing closing stock for tax purposes. The treatment and legislation include the adoption of the IFRS or GAAP in their entirety or substantially. However, some policies reject the IFRS or GAAP substantially and prescribe tax-specific rules for valuing trading stock at year end.

The foreign countries employ various regimens with regard to the valuation of trading stock at year end. Whilst the regimens show some similarities, there are many differences in the approaches followed amongst the countries.

It was established that the valuation of closing inventory in the USA should be in accordance with GAAP. UK GAAP is taken as a starting point for determining the stock valuation for tax purposes in the UK. However, the LIFO method, which is acceptable under UK GAAP, is not acceptable for tax purposes. Valuation methods used in New Zealand are cost, discounted selling price, replacement price and market selling value. In arriving at the cost, GAAP may be used, but the LIFO method is not accepted, only FIFO or weighted average. The USA, UK and New Zealand are grouped under design type I, which adopts the IFRS or GAAP in their entirety or a substantial part thereof.

In Canada, inventory is valued on an item-by-item basis at the lower of cost or fair market value, or the entire inventory may be valued at fair market value. In limited instances, using the NRV method will be acceptable. In Australia, provision is made for the valuation of each closing trading stock item to be valued at cost, market selling value or replacement value. Thus, Canada, Australia and South Africa fall under design type II, which rejects the IFRS or GAAP substantially and employs tax-specific rules.

5.2.3 How does the South African trading stock valuation treatment compare with the identified principles for a good tax system?

Because the study focused on the valuation of trading stock for tax purposes at year end, the most prevalent tax principles were identified and applied in this regard. A two-step approach was followed. First, the South African treatment was evaluated against each relevant principle. Secondly, where the South African treatment seemed inadequate, the treatment in the foreign countries was referred to as possible solutions for the South African treatment.

5.2.3.1 Equity and fairness

The evaluation of the equity and fairness principle focused primarily on the cost of compliance. The SCA has confirmed twice in one year that applying accounting standards in the valuation of trading stock, without reference to the reasons as set out in section 22(1)*(a)* of the ITA, is not accepted for determining the value of trading stock for tax purposes. This places a greater burden on the South African taxpayer when valuing inventory for tax purposes which is not aligned with accounting standards. This burden is caused by the requirement to keep separate records for tax and accounting purposes, resulting in a higher cost of compliance compared with the countries in which the accounting standards are accepted. The South African trading stock valuation treatment with regard to equity and fairness could be regarded as inadequate.

In light of the above, it is suggested that a treatment for tax be employed which is more aligned with the accepted accounting standards. Also, taxpayers could be assisted to correctly adjust their accounting data to be acceptable for tax purposes. However, the latter may place a greater burden on SARS who would need more resources to provide this assistance.

5.2.3.2 Simplicity and certainty

To meet the simplicity and certainty principle with regard to the trading stock valuation treatment, government must ensure that the affected taxpayers are equipped with the required knowledge. This can be achieved by ensuring that the relevant Act is clear on the topic or that detailed interpretation notes are available to guide taxpayers in the valuation exercise. In this way, taxpayers can gain certainty regarding their tax liability relating to trading stock as well as how the valuations will be administered.

From section 22(1) of the ITA it can be concluded that the valuation of trading stock should be reasonable to the Commissioner. Unfortunately, this creates plenty of uncertainty, as it is not stipulated what precisely would be considered as reasonable by the Commissioner. This notion is supported by the recent court cases as referred to in Chapter 2.

It is clear that the South African trading stock valuation treatment does not yet meet the simplicity and certainty principle. However, from the review of the foreign policies in Chapter 3, it can be concluded that the treatment regimens are clear and understandable. The policies of the countries included in the study do not seem to create the same uncertainty as those in South Africa where the Commissioner is granted the power to conclude whether a valuation is reasonable or not.

5.2.3.3 Economic efficiency

Chapter 3 described the special valuation rules for small businesses in some of the identified countries. Small businesses are differently defined in each of these countries. These special rules or concessions to smaller businesses promote not only the ability-to-pay principle, which falls under the broader fairness and equity principle, but also economic efficiency.

A closer alignment with the accounting standards leads to recognising write downs more easily. This provides greater alignment of the treatment with economic activity which, in turn, creates better economic efficiency. In this instance, the taxpayers' accounting records can be used by the revenue authority to verify the valuation for tax purposes.

A closer alignment with accounting standards will also lead to easier write down of losses suffered when trading stock is still on hand. In addition, special rules for trading stock valuation for small businesses may be implemented in order to provide some relief to these businesses.

5.3 FINAL CONCLUSION

From the research it became clear that there may be room for improvement for the South African tax treatment. Some of the practices employed in other countries can be considered as valuable guidelines, together with the identified principles, for improving the South African treatment. The study thus proposes that the main solution for the South African treatment may be for SARS to issue an interpretation note. An interpretation note will provide the taxpayer with more clarity on what is accepted by the Commissioner. Special consideration should be given in the interpretation note to how the Commissioner will apply its discretion.

A more drastic approach would be to change the legislation altogether in order to align the tax and accounting principles – this will contribute to attaining the equity and fairness principle. Equity and fairness may further be promoted by introducing special valuation rules for small businesses. This would provide some relief for these businesses and is likely to improve economic efficiency.

In the light of the uncertainty created by judgments in recent court cases, it was important to conduct this research study, especially to determine whether the South African trading stock valuation treatment complies with the standards of a good tax system. The research revealed a likelihood that more court cases dealing with this issue could occur in the future if these issues are not addressed.

5.4 RECOMMENDATIONS FOR FUTURE RESEARCH

During the course of this research, it was concluded that the South African taxpayer does not seem to be well equipped with the knowledge regarding the tax-specific trading stock valuation treatment regimens. No interpretation note currently exists to assist the taxpayer to evaluate the legislation and provide a clear framework to follow when trading stock is valued.

The study can be extended to suggest an interpretation note regarding trading stock valuation in the South African context. The identified principles for a good tax system may be used as a framework for constructing the suggested interpretation note.

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