



The tax treatment of trading stock

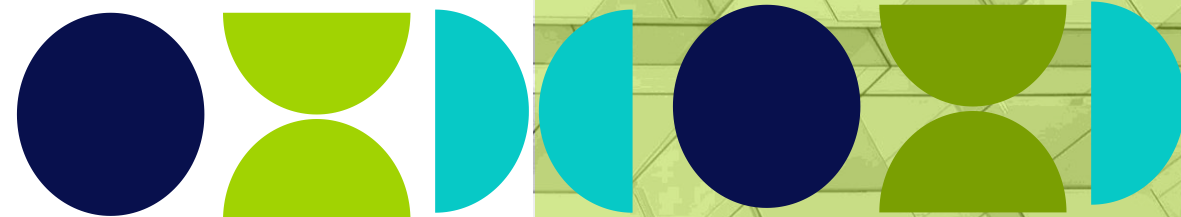
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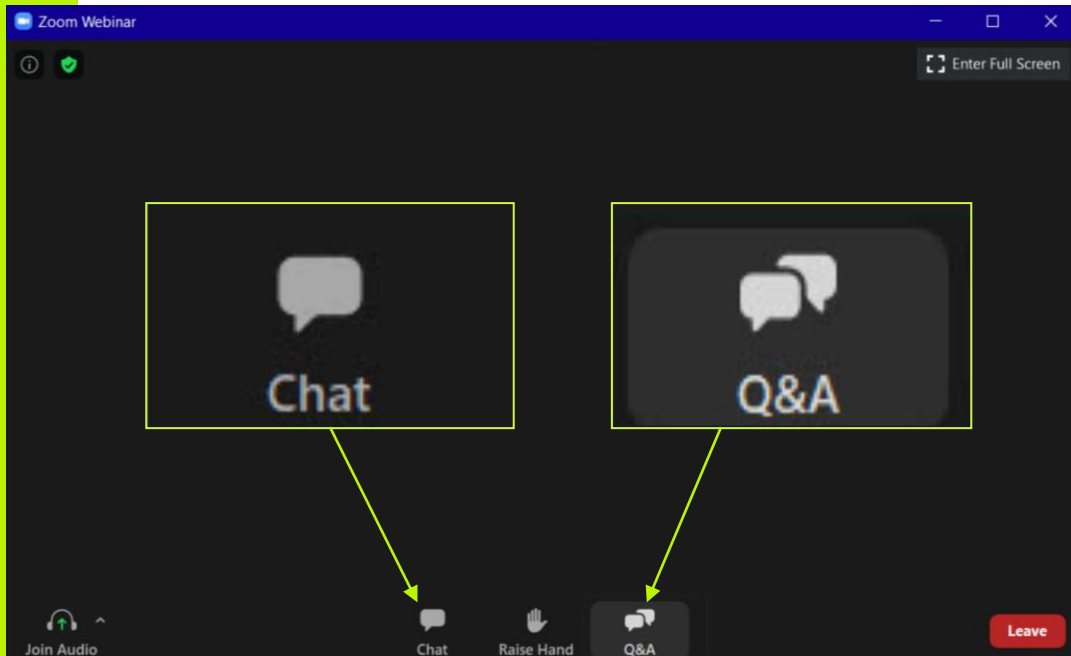
Johan Heydenrych: Director Tax Services

29 June 2022

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ABOUT THE PRESENTER

Johan Heydenrych Kreston South Africa



Johan is a Chartered Accountant who specialised in taxation since 1991. He holds the following qualifications:

- B. Com (Accounting) (Cum Laude)
- B. Com (Accounting) (Hons) (Cum Laude) (Award: "Best student in Audit 700")
- Certificate in the Theory of Accounting
- M. Com (Taxation) (Cum Laude) (Award: "Best M. Com (Tax) student")
- Chartered Accountant (Specialising in Taxation)
- Member of SAICA
- Registered Tax Practitioner

Johan was a tax partner at KPMG from 1997 to 2020 and is currently a partner in the Kreston SA network specialising in taxation.

He provides a wide range of tax services to various clients across industries. These include but are not limited to the following:

- Advice on Tax Risk Management and Tax Governance.
- Tax compliance services including but not limited to ITR 14 and IT 14SD
- Dealing with tax disputes including representing clients at Alternative Dispute Resolution (ADR) hearings.
- Submission of documentation and revised returns under the Voluntary Disclosure Programme.
- Issuing of tax technical opinions on Income Tax, VAT and PAYE. This include preparing briefs to Senior Counsel and submissions of requests for Binding Opinions from SARS.
- Audit support services that includes Normal Tax and Deferred Tax disclosure and disclosure of uncertain tax positions.
- Assistance with implementation of tax reporting for new accounting standards such as IFRIC 23, IFRS 9, IFRS 15 and IFRS 16.
- Facilitation of tax diagnostic sessions with existing and prospective clients.
- Advice on mergers, acquisitions and reorganizations.
- Tax due diligences
- Advice on tax implications of recapitalization transactions, debt restructures, liquidations and deregistration's



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1.

Introduction: Trading Stock

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1. Introduction

The vast majority of businesses makes its money by purchasing goods at a low price and selling it at a higher price.

- For tax purposes, the cost of purchasing inventory is deductible in terms of section 11 (a).
- If the inventory is sold prior to year-end, the gross income is then taxed with the result that the business is taxed on the profit made.
- If the inventory is however unsold at year-end, then the taxpayer must include an amount for trading stock as determined into S22 into its gross income. The following year, the same amount is then deducted as opening stock.
- This means that:
 - S22 represents an amount that must be included in gross income – failure to include the right amount will result in incorrect tax assessment
 - The effect is that a deduction is only received for stock when the stock is disposed of.
- Understanding the principles of “trading stock” is therefore one of the most important factors in ensuring an accurate income tax return.

2.

Definition of trading stock

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2. What is Trading Stock

Trading stock defined – Income Tax Act (s1)

“trading stock” includes—

- (i) anything produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by the taxpayer or on behalf of the taxpayer;
- (ii) anything the proceeds from the disposal of which forms or will form part of the taxpayer’s gross income, ... or
- (iii) any consumable stores and spare parts acquired by the taxpayer to be used or consumed in the course of the taxpayer’s trade; but

Very wide definition – generally corporeal items

Very wide definition – can also include incorporeal items

Specific inclusion

2. What is Trading Stock (continued)

What about WIP for the professional person?
(Accountant, Lawyer, Auditor, Engineer)

- WIP for the professional person is normally time spent on an assignment at a std rate per hour
- This does not constitute “trading stock” as defined.
- The crisp issue for consideration for the professional person is what is the “time of accrual” for income recognition
- The professional person will still need to value consumable stores such as unused files, photocopying paper and other stationery.

3.

Cost price of stock

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3. Cost price of Trading Stock (S22)

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

- (i) subject to subparagraphs (iA) and (ii), be the cost incurred by such person, whether in the current or any previous year of assessment in acquiring such trading stock, plus any further costs incurred by such person, in terms of IFRS (in the case of a company), up to and including the said date in getting such trading stock into its then existing condition and location, but excluding any exchange difference as defined in section 24(1) relating to the acquisition of such trading stock;
- (iA) include an amount that has been included in that person's income in terms of section 8(5), which was applied in reduction or towards settlement of the purchase price of that trading stock;
- (ii) in the case of any trading stock which is in terms of paragraph 12(2)(c) of the Eighth Schedule treated as having been acquired at a cost equal to the market value, be that market value;

Accounting principles are ONLY relevant for purposes of determining the "further costs" elements included in the "cost" of stock.

The "further costs" element stops when the stock is in existing condition and location.

4.

Stock obsolescence

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4. Stock Obsolescence

Trading stock valuation

22. Amounts to be taken into account in respect of values of trading stocks.—

(1) The **amount** which shall, in the determination of the taxable income derived by any person during any year of assessment from carrying on any trade (other than farming), be taken into account in respect of the value of any trading stock held and not disposed of by him at the end of such year of assessment, shall be—

(a) in the case of trading stock other than trading stock contemplated in [paragraph \(b\)](#), the **cost price to such person of such trading stock**, less such amount as the Commissioner **may think just and reasonable** as representing the amount by which the **value** of such trading stock, not being any financial instrument, has been diminished by reason of damage, deterioration, change of fashion, decrease in the market value or for any other reason **satisfactory to the Commissioner**: Provided that for the purposes of this subsection—

- (i) the **amount of trading stock** must be taken into account in determining taxable income by including **such amount** in gross income; and
- (ii) in determining any diminution in the value of trading stock, **no account must be taken of the fact that the value of some items of trading stock held and not disposed of by the taxpayer may exceed their cost price;**

The term “value” is explored in case law. There is a difference between “fair value” and “net realisable value”

An ACTIVE step from SARS is required. SARS must “think”...

It is a single amount that must be included in gross income. Stock obsolescence is not a “deduction” claimed, but a methodology to arrive at this single amount that must be included in gross income.

**THE SUPREME COURT OF APPEAL OF SOUTH AFRICA
JUDGMENT**



Reportable

Case no: 1028/2017

In the matter between:

**THE COMMISSIONER FOR THE SOUTH
AFRICAN REVENUE SERVICE**

APPELLANT

and

VOLKSWAGEN SOUTH AFRICA (PTY) LTD

RESPONDENT

Neutral citation: *C:SARS v Volkswagen S A (Pty) Ltd* (1028/2017)

[2018] ZASCA 116 (19 September 2018)

SARS v Volkswagen SA (Pty) Ltd

- [45] The calculation of NRV was based on a standardised 'Wholesale Selling Price' for each vehicle. Similarly the amounts deducted from that figure were standard amounts in respect of each vehicle model.
- An NRV adjustment was made when the NRV was less than the cost of each item of stock. The overall deduction in respect of the NRV of vehicles was made in respect of those vehicles only.
- There is no suggestion of an adjustment in the opposite direction, where the NRV was higher than the cost price.
- **This accords with IAS 2, clause 29 of which requires that NRV must be determined item by item, unless that is impractical.** In that 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 as yet taken place.

SARS v Volkswagen SA (Pty) Ltd

- [51] IAS 2 makes the point that NRV is different from fair value.
 - The latter is the amount for which an asset could be exchanged or a liability settled between knowledgeable and willing parties in an arm's length transaction in the market.
 - The passage quoted from Volkswagen's notice of objection appears to confuse the two.
 - Fair value reflects the current value of the goods in the market.
 - NRV reflects the amount it is thought they will realise in the market at some future date.
 - Fair value seems more closely related to an assessment of the value of trading stock at a specific point in time.
- [52] Apart from these practical difficulties, the use of NRV is inconsistent with two basic principles that underpin the Act.
 - The first is that taxable income is determined and taxation levied from year to year on the basis of events during each tax year.
 - The Commissioner is not concerned, save where allowances such as depreciation or provisions for bad debts are concerned, with the taxpayer's trading prospects in later years.
 - This principle is sometimes expressed by saying that taxation is backward looking.
 - By contrast NRV is explicitly forward looking. It is concerned with the amount that the trader is likely to receive when the goods are realised and for that reason it takes account of the expenses that will be incurred in making the sale.

Disagree with this statement. The cost of stock is deducted in a current year. The question is what is the "net amount" that must be included in gross income.

SARS v Volkswagen SA (Pty) Ltd

- [53] The second inconsistency with principle is that using NRV has the effect that expenses incurred in a future tax year in the production of income accruing to or received by the taxpayer in that future tax year, become deductible in a prior year.
 - That is inconsistent with the basic deduction provision in s 11(a) of the Act, that what may be deducted in any tax year in the determination of taxable income is 'expenditure and losses actually incurred in the production of the income'.
 - Allowing Volkswagen to deduct in a current year expenses that will be incurred in the following year in earning income flies in the face of that provision.

SARS v Volkswagen SA (Pty) Ltd

- [55] A concern that arose in the course of argument was whether any part of the items taken into account by Volkswagen in the calculation of NRV could legitimately have founded a contention that to some degree, albeit not to the extent reflected in the NRV, events had occurred that justified the Commissioner in making an allowance in favour of the taxpayer under s 22(1)(a).
- On careful consideration of the items making up the NRV calculation it appears that the only possibility in that regard would have been damage to vehicles justifying the rework/refurbishment claim.
- However, that was a minor item that on its own would not have had the effect of diminishing the value of the trading stock to the extent required to warrant the Commissioner making an allowance in favour of the taxpayer.

In my opinion, the legal interpretation is as stated in the VWSA SCA case is correct, namely that one should only take into account any events that occurred up to year-end and not thereafter.

- However the factual scenario was incomplete.
- The Audi that is imported is a vehicle WITHOUT a Motor Plan.
- In considering the true value of that vehicle, one should consider what that vehicle can be sold for in the market WITHOUT the Motor Plan.
- It is about comparing apples with apples.
- This was not raised by the defence.
- Similarly, the cost of the vehicle is for a vehicle in Uitenhage. The question should be what is the Market Value of the vehicle if the customer need to collect the vehicle in Uitenhage.



Law amendment following VWSA case

- *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 price.*
- *The overall position with a company that is a going concern will probably be that the NRV of the trading stock, taken as a whole, will be greater than cost price.*
- *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 Volkswagen's trading stock as a whole had suffered a diminution in value.*

The judge stated that even if an element of stock has diminished in value, this may be offset by other stock items that have a higher value than cost

This problem was addressed by way of an amendment to the law which is effective from years of assessment commencing on or after 1 January 2020.

2 "Provided that for the purposes of this subsection— ... (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; ”.



**THE SUPREME COURT OF APPEAL OF SOUTH AFRICA
JUDGMENT**

Reportable

Case no: 834/2018

In the matter between:

**THE COMMISSIONER FOR THE SOUTH AFRICAN
REVENUE SERVICE**

APPELLANT

and

ATLAS COPCO SOUTH AFRICA (PTY) LTD

RESPONDENT

4. Stock obsolescence (continued)

The facts

- The taxpayer, Atlas Copco SA (Pty) Ltd, is a member of the Atlas Copco Group, with its parent company in Sweden.
- The main business of the taxpayer is to sell or lease – and thereafter service – machinery and equipment (including spare parts and consumables) that is imported mainly from Sweden, for use in the mining and related industries in South Africa.
- The taxpayer's parent company had conceived a policy known as the Finance Controlling and Accounting Manual (FAM) or The Way We Do Things (WAY), which was implemented and applied by all companies within the group.
- In terms of the policy, the taxpayer was to write down the value of its closing stock by
 - 50%, if such closing stock had not sold in the preceding 12 months, and by
 - 100% if it had not sold in 24 months.

4. Stock obsolescence (continued)

The facts

- The taxpayer applied the policy by writing down its closing stock by the fixed percentages reflected in the policy.
- It included in its 2008 and 2009 tax returns the amounts it claimed the value of its trading stock had diminished by during those years of assessment.
- SARS, however, took the view that the write down of stock by the taxpayer did not comply with the provisions of s 22(1)(a) of the Act. SARS accordingly added back R30 191 000 for 2008 and R33 402 000 for 2009 and assessed the taxpayer to tax in respect of those amounts on the ground that 'there was no diminishing in value at year end for a deduction to be claimed as a result of damage, deterioration, change of fashion, decrease in the market value in respect of stock'.

4. Stock obsolescence (continued)

Finding of the Special Court

The Special Court found that SARS failed to exercise its discretion around the obsolescence of the stock.

Due to the failure of SARS to exercise its discretion, the Court will then exercise the discretion in its stead as follows:

- The NRV as determined in accordance with IAS2, IFRS and SA GAAP and the policy, provides an acceptable and appropriate method for purposes of section 22(1)(a) for the determination of the actual value of trading stock at the end of the year of assessment, the application of which leads to a sensible and business-like result.
- It constitutes a just and reasonable basis for valuing SA Copco SA's closing stock for 2008 and 2009, as contemplated in such section.

But....

It was a different story for the Taxpayer in the Supreme Court of Appeal....



Latin for "he himself said it" meaning the only proof we have of the fact is that this person said it

Importance of the "*ipse dixit*" of the Taxpayer

Evidence from Business Controller

And that's why I put to you, Mr Smit, that on the information conveyed to the Commissioner, Atlas's stance is we don't look at anything else.

*If it falls under a category, by virtue of its ageing, it is classified as such and it is then written off accordingly, either by 50% or 100%. And that's the method that was applied in 2008 and 2009.
Yes?*



Yes, I agree to that. It's because that is the method that has been identified which makes it, I could say, the most logical for us to be able to analyse the level of items that we have to do. I can't recall that there's any other recommendation from the Commissioner as to what method we should apply. We just need to get to an assessment, but how do you get to it, so this is the method that we've used.

Evidence from Business Controller

So, the answer to my question is yes, Atlas did not take into account the price at which it had sold stock during that year? It relied on a method, in terms of which it had applied a 50% write-off, if it fell into a 12 month bucket, and a 100% write-off if it fell in a 24 months bucket?



M'Lady, if that's the interpretation of the Commissioner, from that side, from our side, we, you know, we apply a method. Because if we look at, we have about 20000 items actively, any day in time, to go and to try and to do that specific verification item by item, with the relevant pricing confirmations, will be a gigantic and an impossible task to do.

Evidence from External Auditor

You don't test and nor were those your instructions, to test whether the stock that had been there for 12 months or 24 months should be written off at a lesser percentage or a higher percentage?



No, that wasn't part of our audit, that would have been looked at by the Group audit

Evidence from External Auditor

*And you accepted as I understood, ...
I'm told that this is the policy that they
have to [apply] and I now test to see
whether they've applied it.*



*Yes, and they implied that it was in
terms of IFRS.'*

Finding of the judge....



It follows, despite the Tax Court's acceptance of Ms Towlson's (the auditor's) evidence, that her evidence did little to advance the taxpayer's case. If anything, Ms Towlson's evidence serves to fortify the view that the taxpayer's employment of a fixed and rigid company policy was arbitrary and did not present the most reliable evidence available at the time in respect of any diminution in value.

What is more, Ms Towlson's audit team recorded that the taxpayer's group policy was 'a very aggressive policy' and for that reason, the risk of inventories being carried at more than their NRV was deemed low 'considering the aggressive write down policy'.

Finding of the judge....



It must follow from what has thus far been stated that the taxpayer's approach to the valuation of its trading stock is flawed. That, ordinarily at any rate, ought to be dispositive of the appeal against it.

The taxpayer thus appears to have taken no account of any diminution in value in respect of such stock. Its approach simply was: because we had not sold all of the items, who is to know whether we will be able to sell what remains of the stock. The write off was thus at best an unmotivated guesstimate.

Finding of the judge....



- *It is apparent when the evidence relating to all six categories 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.*

Finding of the Supreme Court of Appeal

- Section 22(1)(a) is concerned with the value of the trading stock of a taxpayer as trading stock at year end.
- It empowers SARS to allow a deduction from the cost price, by way of a just and reasonable allowance, in the four circumstances specified namely,
 - damage,
 - deterioration,
 - change of fashion or
 - decrease in market value or
 - for any other reason satisfactory to the SARS.
- The rationale for the existence of these provisions 'is neither far to seek nor difficult to comprehend'.
- The section is couched in the past tense.
- It is concerned with an enquiry as to whether a diminution in value has already occurred.
- In other words, the cost price must already have diminished.
- The circumstances expressly mentioned in the section relate to a diminution of value as a result of events occurring prior to the rendition by the taxpayer of its tax return.
- The exercise is thus one of looking back at what happened during the tax year in question.

Finding of the Supreme Court of Appeal

- Whilst there is obvious scope for an overlap between the provisions of s22(1)(a) and those of IAS2, not all of the elements to which the latter refers relate to the same matters as the section.
- The determination of NRV is firmly based on an assessment of future market conditions.
- The use of NRV is thus inconsistent with two basic principles that underpin the Act.
 - The first is that taxable income is determined and taxation levied from year to year on the basis of events during each tax year. By contrast, NRV is explicitly forward looking.
 - The second is that using NRV has the effect that expenses incurred in a future tax year in the production of income accruing to or received by the taxpayer in that future tax year, become deductible in a prior year.
- The Act's provisions do not necessarily accord with current accounting principles.

Need to do something different for tax.
What is that?

Does this court case mean that one is not allowed to consider the ageing of stock in order to determine stock obsolescence from a tax perspective?

Not at all. In this case, the taxpayer and its auditors blindly accepted a global policy without any substantive tests. If the stock obsolescence policy was stress-tested and evidence could be provided that it is reasonable, then the outcome of the court case may well have been different.



The ipse dixit of the taxpayer is very important when the court need to make a judgement.

What does this mean in practice?

- SARS is significantly more litigious than ever before and is confident given a 80% success rate in the appeal court.
- It is not only whether there is “an argument” to support the taxpayer’s contention.
- The Public Officer/Director/Financial Manager must convincingly, under robust cross examination be prepared to support that argument.



5.

Trading stock for the farmer

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Trading stock valuation

22. Amounts to be taken into account in respect of values of trading stocks.—

(1) The amount which shall, in the determination of the taxable income derived by any person during any year of assessment from carrying on any trade (other than farming), be taken into account in respect of the value of any trading stock held and not disposed of by him at the end of such year of assessment, shall be—

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

Section 22 does not apply to farming

But Par 2 of the 1st Schedule states the following:

*Every farmer shall include in his return rendered for income tax purposes the value of all **livestock** or **produce** held and not disposed of by him at the beginning and at the end of each year of assessment.*

Stock for the farmer

- Not covered by S22
- Livestock included at standard values
 - But subject to ringfencing requirements
- “Produce” included at “fair and reasonable” value. (SARS accepts lower of production cost or Market Value)
 - The term “market value” is not defined for the purposes of the First Schedule but in the context would bear its ordinary meaning of the price which could have been obtained upon a sale of the produce between a willing buyer and a willing seller dealing at arm’s length in an open market.
 - The value of production costs is determined by considering expenditure allowable for income tax purposes, excluding expenditure deductible under paragraph 12.
- If the item is not “livestock” and not “produce” then it is not included in gross income
 - Consumables
 - Fertiliser
 - Standing crops
 - Fuel
 - Packing material (but only to the extent that it relates to farming activities)

The nursery operator

INTERPRETATION NOTE 79 (Issue 2)

DATE: 23 November 2017

ACT : INCOME TAX ACT 58 OF 1962

SECTION : SECTIONS 9HA, 25, 25C AND 26 AND PARAGRAPHS 2, 3, 4 AND 9 OF THE FIRST SCHEDULE

SUBJECT : PRODUCE HELD BY NURSERY OPERATORS

Nursery produce

- Section 22 deals with amounts to be taken into account in respect of the value of trading stock and specifically excludes farming.
- Under paragraph 2 of the First Schedule a nursery operator's return of income must include the value of all produce held and not disposed of at the beginning and at the end of each year of assessment.
- The plants or trees grown by a nursery, which are not ready for sale, will fall into the category of growing crops and must not be brought into account when the taxable income from farming operations is determined.
- The question whether a bulb is produce for tax purposes will depend on the reason for its removal from the soil.
 - Bulbs which are removed from the soil for sale will comprise produce.
 - Bulbs removed from the soil as part of a natural growing cycle, for example, with the intention of replanting them in preparation for the next season, will not comprise produce since they are not ready for sale.
 - The onus is on the nursery operator to distinguish between the two types of bulbs.
- A difficulty arises with seedlings and other plant material (including bulbs) produced and grown in containers for ultimate sale in the same containers. SARS accepts that such items will have a value as produce only once they have matured sufficiently to be in a saleable condition. The onus remains on the nursery operator to make that determination on a sound basis.
- Any trading stock purchased from outside sources and offered for sale is not attributable to farming operations and must be dealt with under section.

INTERPRETATION NOTE 79 (Issue 2)

DATE: 23 November 2017

ACT : INCOME TAX ACT 58 OF 1962
SECTION : SECTIONS 9HA, 25, 25C AND 26 AND PARAGRAPHS 2, 3, 4 AND 9 OF THE FIRST SCHEDULE
SUBJECT : PRODUCE HELD BY NURSERY OPERATORS

The nursery operator

Nursery produce

- The related expenditure incurred in getting the plants, trees, seedlings or bulbs to a marketable state should generally be deductible under section 11(a) read with section 23(g) on the basis that it was incurred in the production of income in carrying on a trade.
- Examples of such expenditure include labour and fertilizer.
- Capital development expenditure incurred on items such as irrigation schemes and the erection of farm buildings will qualify for deduction under paragraph 12 provided all the requirements of that provision are met.
- The proceeds derived from the sale of the plants and bulbs are included in gross income in the year of assessment in which the sale takes place.

INTERPRETATION NOTE 79 (Issue 2)

DATE: 23 November 2017

ACT : INCOME TAX ACT 58 OF 1962
SECTION : SECTIONS 9HA, 25, 25C AND 26 AND PARAGRAPHS 2, 3, 4 AND 9 OF THE FIRST SCHEDULE
SUBJECT : PRODUCE HELD BY NURSERY OPERATORS

The nursery operator

Valuation method

- Paragraph 9 stipulates that the value to be placed on produce included in any return shall be a fair and reasonable value.
- A reasonable value is considered to be the lower of production cost or market value.
- The term “market value” is not defined for the purposes of the First Schedule but in the context would bear its ordinary meaning of the price which could have been obtained upon a sale of the produce between a willing buyer and a willing seller dealing at arm’s length in an open market.
- The value of production costs is determined by considering expenditure allowable for income tax purposes, excluding expenditure deductible under paragraph 12.

6.

Spare Parts

tax happy hour

Trading stock defined

“trading stock” includes—

- (iii) any consumable stores and spare parts acquired by the taxpayer to be used or consumed in the course of the taxpayer’s trade.

The accounting treatment is often inconsistent –

- Major spare parts e.g. spare conveyor belts, engines for aircraft etc are often capitalised and written off as PPE
- Minor spare parts e.g. clutch kits, scanning equipment etc is separately reflected as stock

Examples:

- Spare engine for aircraft
- Spare conveyor belts
- Spare gearboxes
- Spare clutches



Spare Parts

- Whilst not yet used – Stock
- Used to replace existing part – arguably a section 11 (d) deduction
- What about when existing part is taken into stock, refurbished for reuse?

7.

Construction contracts

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Construction Contracts: Accounting Treatment

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Construction Contracts – IFRS for SMEs

- When the outcome of a construction contract can be estimated reliably, an entity shall recognise contract revenue and contract costs associated with the construction contract as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period (often referred to as the percentage of completion method).
- Reliable estimation of the outcome requires reliable estimates of the stage of completion, future costs and collectability of billings.
- The requirements of this section are usually applied separately to each construction contract.
- However, in some circumstances, it is necessary to apply this section to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.

Percentage of completion method – IFRS for SMEs

An entity shall determine the stage of completion of a transaction or contract using the method that measures most reliably the work performed.

Possible methods include:

- (a) the proportion that costs incurred for work performed to date bear to the estimated total costs. Costs incurred for work performed to date do not include costs relating to future activity, such as for materials or pre-payments.
- (b) surveys of work performed.
- (c) completion of a physical proportion of the service transaction or contract work.

Progress payments and advances received from customers often do not reflect the work performed – **What does this mean for the tax computation?**

Direct expenditure of Contract Costs

An entity shall recognise costs that relate to future activity on the transaction or contract, such as for materials or prepayments, **as an asset if it is probable that the costs will be recovered.**

An entity shall recognise as an expense immediately any costs whose recovery is **not probable.**

When the outcome of a contract cannot be estimated reliably:

- (a) an entity shall recognise revenue only to the extent of contract costs incurred that it is probable will be recoverable; and
- (b) the entity shall recognise **contract costs** as an expense in the period in which they are incurred.

When it is probable that total contract costs will exceed total contract revenue on a contract, the expected loss shall be recognised as an expense immediately, with a corresponding provision for an **onerous contract.**

If the collectability of an amount already recognised as contract revenue is no longer probable, the entity shall recognise the uncollectable amount as an expense instead of as an adjustment of the amount of contract revenue.

Construction Contracts: Tax Treatment

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Adjustments relating to long term construction contracts

Current year: Cumulative amounts

Cumulative payments received/income unconditionally accrued on LT construction contracts	(+)
Cumulative costs incurred on LT construction contracts	(-)
Section 22(2A) value of trading stock where costs to date exceed income to date	(+)
Section 22 reduction of value of trading stock where costs exceeds NRV	(-)
Section 24C allowance for future costs	(-)
Cumulative accounting loss/(profit) recognised on open contracts	(+)(-)

Prior year

Cumulative payments received/income unconditionally accrued on LT construction contracts	(-)
Cumulative costs incurred on LT construction contracts	(+)
Section 22(2A) value of trading stock where costs to date exceed income to date	(-)
Section 22 reduction of value of trading stock where costs exceeds NRV	(+)
Section 24C allowance for future costs	(+)
Cumulative accounting loss/(profit) recognised on open contracts	(+)(-)

S22(2A) (a) Where any person carries on any construction, building, engineering or other trade in the course of which improvements are effected by him to fixed property owned by any other person, any such improvements effected by him and any materials delivered by him to such fixed property which are no longer owned by him shall, until the contract under which such improvements are effected has been completed, be deemed for the purposes of this section to be trading stock held and not disposed of by him.

Adjustments relating to long term construction contracts

Current year: Cumulative amounts

Cumulative payments received/income unconditionally accrued on LT construction contracts	(+)
Cumulative costs incurred on LT construction contracts	(-)
Section 22(2A) value of trading stock where costs to date exceed income to date	(+)
Section 22 reduction of value of trading stock where costs exceeds NRV	(-)
Section 24C allowance for future costs	(-)
Cumulative accounting loss/(profit) recognised on open contracts	(+)(-)

Prior year

Cumulative payments received/income unconditionally accrued on LT construction contracts	(-)
Cumulative costs incurred on LT construction contracts	(+)
Section 22(2A) value of trading stock where costs to date exceed income to date	(-)
Section 22 reduction of value of trading stock where costs exceeds NRV	(+)
Section 24C allowance for future costs	(+)
Cumulative accounting loss/(profit) recognised on open contracts	(+)(-)

(3A) For the purposes of this section the cost price of trading stock referred to in subsection (2A) shall be the sum of the cost to the taxpayer of material used by the taxpayer in effecting the relevant improvements, and such further costs incurred by the taxpayer as in accordance with IFRS are to be regarded as having been incurred directly in connection with the relevant contract, and such portion of any other costs incurred by the taxpayer in connection with the relevant contract and other contracts as in accordance with IFRS are to be regarded as having been incurred in connection with the relevant contract, less a deduction of so much of—

(a) any income received by or accrued to the taxpayer in respect of the relevant contract;

(b) any portion of an amount payable to the taxpayer under the relevant contract (but not exceeding 15 per cent of the total amount payable to him under such contract) the payment of which has been withheld as a retention; and

(c) any of the said costs included under this subsection as exceed that portion of the contract price which relates to the improvements actually effected by him,

as does not exceed the said sum.

8.

Change in use

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Income Tax Risks: Donation of stock

Legislation	Application
<p>(8) If during any year of assessment— (b) any— (i) taxpayer has applied trading stock for the purpose of making any donation thereof;</p> <p>and the cost price of such trading stock has been taken into account in the determination of the taxable income of the taxpayer for any year of assessment, the taxpayer shall be deemed to have recovered or recouped...</p> <p>(C) where such trading stock has been applied for the purpose of making a donation in respect of which the provisions of section 18A apply, an amount equal to the amount which was taken into account for that year of assessment in respect of the value of that trading stock,</p> <p>and such amount shall be included in the income of the taxpayer for the year of assessment during which such trading stock was so applied, disposed of, distributed or ceased to be held as trading stock:</p>	<p>This means that if stock is donated to a PBO in return for a section 18A certificate, the cost of the stock is recouped meaning that there is no income tax loss/gain.</p> <p>That same amount will then be considered for a S 18A deduction.</p>

Income Tax Risks: Private use of stock

Legislation

(8) If during any year of assessment— (a) any taxpayer has applied trading stock to his private or domestic use or consumption

and the cost price of such trading stock has been taken into account in the determination of the taxable income of the taxpayer for any year of assessment, the taxpayer shall be deemed to have recovered or recouped...

(A) where such trading stock has been applied in a manner contemplated in [paragraph \(a\)](#), an amount equal to the cost price to him of such trading stock (less any sum which has been deducted therefrom under the provisions of [subsection \(1\)](#)) or where the cost price cannot be readily determined, the market value of such trading stock;

and such amount shall be included in the income of the taxpayer for the year of assessment during which such trading stock was so applied, disposed of, distributed or ceased to be held as trading stock:

Application

This means that if a taxpayer uses the stock for private purposes, then the cost is recouped.

VAT Risks

Where stock is applied for non-taxable use, then output VAT is payable on the market value of such stock

e.g. Where a mine/farmer/co-op takes stock from the stores and applies it to effect repairs to residential accommodation

9.

Township development

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Section 24 of the Income Tax Act

24. Credit agreements and debtors allowance.—

- (1) Subject to the provisions of [section 24J](#), if any taxpayer has entered into any agreement with any other person in respect of any property the effect of which is that, in the case of movable property, the ownership shall pass or, in the case of immovable property, transfer shall be passed from the taxpayer to that other person, upon or after the receipt by the taxpayer of the whole or a certain portion of the amount payable to the taxpayer under the agreement, the whole of that amount shall for the purposes of this Act be deemed to have accrued to the taxpayer on the day on which the agreement was entered into.
- (2) In the case of such an agreement in terms of which at least 25 per cent of the said amount payable only becomes due and payable on or after the expiry of a period of not less than 12 months after the date of the said agreement, the Commissioner, taking into consideration any allowance he has made under [section 11 \(j\)](#), may make such further allowance as under the special circumstances of the trade of the taxpayer seems to him reasonable, in respect of all amounts which are deemed to have accrued under such agreements but which have not been received at the close of the taxpayer's accounting period: Provided that any allowance so made shall be included as income in the taxpayer's returns for the following year of assessment and shall form part of his income.

Gross income arises when contract is signed!!!

Very complex legislation
No guidance from SARS
Mostly incorrectly applied
for Township development

2 elements:

1. Debtor allowance for o/s debt (GP percentage)
2. Contingency development expenses (future actual expenses)

Example of Township development

Allowance for outstanding debt

$$w = (x - [y + z]) / x$$

w = Percentage claimable

y = Actual costs to date

z = Total estimated costs to be incurred

x = Expected total proceeds

Allowance for contingent development expenditure

$$r = (m/n)(d-a)$$

r = annual allowance

m = number of plots sold to date

n = number of plots available for sale

d = total development expenditure to be incurred

a = actual cumulative development expenditure to date

		Year 1	Year 2	Year 3	Year 3
Price per erf		300 000	300 000	300 000	300 000
Total number of stands available for sale	n	500	500	500	500
Total number of stands already signed	m	200	360	500	500
Expected total proceeds	X	150 000 000	150 000 000	150 000 000	150 000 000
Total value of stands already sold		60 000 000	108 000 000	150 000 000	150 000 000
Total cost of the land	a and y	10 000 000	10 000 000	10 000 000	10 000 000
Total anticipated development cost	z and d	100 000 000	100 000 000	100 000 000	100 000 000
Total actual development cost to date	a	30 000 000	60 000 000	90 000 000	100 000 000
Outstanding debt		60 000 000	108 000 000	150 000 000	
Allowance for outstanding debt (Gross profit percentage)	w	26.67%	26.67%	26.67%	26.67%
Allowance for contingent development expenditure	r	28 000 000	28 800 000	10 000 000	0
Tax computation					
Include gross income cumulative	CY	60 000 000	108 000 000	150 000 000	150 000 000
	PY		-60 000 000	-108 000 000	-150 000 000
Deduct cost of land		-10 000 000	-10 000 000	-10 000 000	-10 000 000
			10 000 000	10 000 000	10 000 000
Deduct actual development costs cumulative	CY	-30 000 000	-60 000 000	-90 000 000	-100 000 000
	PY		30 000 000	60 000 000	90 000 000
Section 22 trading stock					
Closing stock		0	0	0	0
Opening stock			0	0	0
Section 24 allowance					
Allowance for outstanding debt (Gross profit percentage)	CY	-16 000 000	-28 800 000	-40 000 000	0
	PY		16 000 000	28 800 000	40 000 000
Allowance for contingent development expenditure	CY	-28 000 000	-28 800 000	-10 000 000	0
	PY		28 000 000	28 800 000	10 000 000
Assessed loss brought			-24 000 000	-19 600 000	0
Taxable income		-24 000 000	-19 600 000	0	40 000 000

Example of section 24

Allowance for outstanding debt

$$w = (x - (y + z)) / x$$

w = Percentage claimable

y = Actual costs to date

z = Total estimated costs to be incurred

x = Expected total proceeds

Allowance for contingent development expenditure

$$r = (m/n)(d-a)$$

r = annual allowance

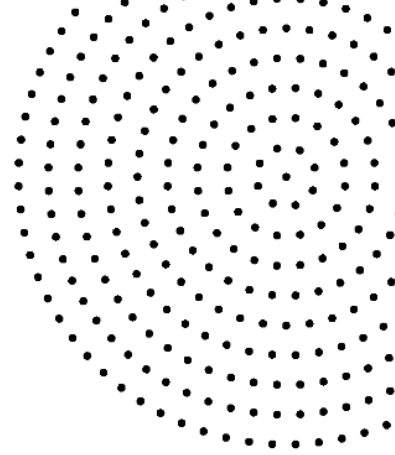
m = number of plots sold to date

n = number of plots available for sale

d = total development expenditure to be incurred

a = actual cumulative development expenditure to date

		Year 1	Year 2	Year 3	Year 3
Price per erf		300 000	300 000	300 000	300 000
Total number of stands available for sale	n	500	500	500	500
Total number of stands already signed	m	0	30	500	500
Expected total proceeds	X	150 000 000	150 000 000	150 000 000	150 000 000
Total value of stands already sold		0	9 000 000	150 000 000	150 000 000
Total cost of the land	a and y	10 000 000	10 000 000	10 000 000	10 000 000
Total anticipated development cost	z and d	100 000 000	100 000 000	100 000 000	100 000 000
Total actual development cost to date	a	30 000 000	60 000 000	90 000 000	100 000 000
Outstanding debt		0	9 000 000	150 000 000	150 000 000
Allowance for outstanding debt (Gross profit percentage)	w	26.67%	26.67%	26.67%	26.67%
Allowance for contingent development expenditure	r	0	2 400 000	10 000 000	0
Tax computation					
Include gross income cumulative	CY	0	9 000 000	150 000 000	150 000 000
	PY		0	-9 000 000	-150 000 000
Deduct cost of land		-10 000 000	-10 000 000	-10 000 000	-10 000 000
			10 000 000	10 000 000	10 000 000
Deduct actual development costs cumulative	CY	-30 000 000	-60 000 000	-90 000 000	-100 000 000
	PY		30 000 000	60 000 000	90 000 000
Section 22 trading stock					
Closing stock		40 000 000	61 000 000	0	0
Opening stock			-40 000 000	-61 000 000	0
Section 24 allowance					
Allowance for outstanding debt (Gross profit percentage)	CY	0	-2 400 000	-40 000 000	0
	PY		0	2 400 000	40 000 000
Allowance for contingent development expenditure	CY	0	-2 400 000	-10 000 000	0
	PY		0	2 400 000	10 000 000
Assessed loss brought			0	-4 800 000	0
Taxable income		0	-4 800 000	0	40 000 000



THANK YOU

For joining us.
Stay In touch.
www.saiba.org.za

SEE YOU AGAIN

20 July 2022
Wednesday

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