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)

Coram: NAVSA, SERITI, WALLIS, WILLIS and MATHOPO JJA

Heard: 6 September 2018

Delivered: 19 September 2018

Summary: Income tax – valuation of stock at year end – s 22(1)(*a*) of Income Tax Act 58 of 1962 – whether stock to be valued in accordance with International Accounting Standard 2 (IAS 2 or AC 108) at net realisable value.

ORDER

On appeal from: Tax Court, Port Elizabeth (Eksteen J and assessors):

1 The appeal succeeds with costs, such costs to include those consequent upon the employment of two counsel.

2 The order of the Tax Court is set aside and replaced by an order dismissing the appeal and confirming the additional assessments for the 2008, 2009 and 2010 years of assessment.

JUDGMENT

Wallis JA (Navsa, Seriti, Willis and Mathopo JJA concurring)

[1] Volkswagen of South Africa (Pty) Ltd (Volkswagen), the respondent in this appeal, is the South African subsidiary of the well-known German motor manufacturer, Volkswagen AG. At the end of each tax year, Volkswagen holds as trading stock a number of unsold vehicles. Some of these are manufactured or, in the case of trucks and buses assembled, at its plant in Uitenhage, while others are imported, and a certain number of second hand vehicles are drawn from its own fleet. In determining its taxable income it is obliged by s 22(1)(*a*) of the Income Tax Act 58 of 1962 (the Act) to attach a value to that trading stock. Ordinarily that value is the cost price of the stock calculated in accordance with the provisions of the Act.

[2] In its returns for 2008, 2009 and 2010 tax years Volkswagen calculated the value of its trading stock at year end using its ‘net

realisable value' (NRV) in accordance with the provisions of International Accounting Standard 2 (IAS 2) and the IFRS-Accounting Handbook for the Volkswagen Group. This yielded an amount less than the cost price of the trading stock and it claimed a deduction from the cost price of the trading stock represented by the difference between that and NRV.

[3] The Commissioner for the South African Revenue Service (SARS or the Commissioner, as the context requires), the present appellant, conducted a lengthy audit of Volkswagen's tax affairs covering a wide range of issues for the tax years 2008, 2009 and 2010. At the end of it the Commissioner rejected the contention that NRV represented the diminished value of the trading stock at the end of those years. The differences between cost price and NRV for the three years in dispute were respectively R72 002 161, R24 778 855 and R5 294 643. The refusal of an allowance in these amounts resulted in the issue of revised assessments levying additional tax for those three years. Volkswagen appealed against those assessments. The Tax Court (Eksteen J and assessors) upheld the appeal and set the revised assessments aside. The present appeal lies directly to this Court in accordance with leave granted by Eksteen J.

The issue

[4] In determining its taxable income, a trading entity is entitled to deduct from its income[1] expenses incurred in the production of that income. During the tax years in question Volkswagen derived income

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[1] Income is the amount remaining after deducting from its gross income all amounts that are exempt from tax. *Commissioner for Inland Revenue v Nemojim (Pty) Ltd* 1983 (4) SA 935 (A) at 946G-H. The three expressions 'gross income', 'income' and 'taxable income' are defined in s 1 of the Act.

from the sale of motor vehicles and was therefore entitled to deduct from that income the costs incurred in the production and acquisition of those motor vehicles. But, from a timing perspective, there was not a perfect correlation between the income it earned during any given year and the costs it incurred in that year in the manufacture and acquisition of its trading stock. Some of the income flowed from the sale of trading stock on hand at the commencement of the tax year. Some of the costs incurred in manufacturing or acquiring motor vehicles were incurred in relation to vehicles that formed part of its trading stock at the close of the tax year and would be sold in a future tax year. In order to reflect its taxable income accurately, the value of trading stock at the beginning of the tax year and sold during the year was included in its cost of sales and the value of its trading stock at the end of the tax year was deducted from the cost of sales. In this way it determined the actual cost of the sales effected during the tax year and the sales effected during the year were matched with the cost of effecting those sales.

[5] In formulating the annual accounts of trading entities that buy and sell any type of commodity or goods, accountants always undertake an exercise of this type. After the judgment in *Commissioner for Inland Revenue v Jacobsohn*,[2] it became the general practice of the revenue authorities to require taxpayers to formulate their tax returns on that basis, although it was not expressly provided for in the then taxation legislation and there were arguments that it was inconsistent therewith.[3] Statutory provisions were introduced to deal with the situation in 1956.[4]

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[2] *Commissioner for Inland Revenue v Jacobsohn* 1923 CPD 221 (*Jacobsohn*). See the explanation by Marais JA in *Richards Bay Iron & Titanium (Pty) Ltd and Another v Commissioner for Inland Revenue* 1996 (1) SA 311 (AD) at 316F-317C.
[3] See (1955) 4 *The Taxpayer* 21.
[4] *Commissioner for Inland Revenue v Nemojim (Pty) Ltd*, supra, at 956G-957C.

[6] From a tax perspective, the higher the value attributed to closing stock at the end of a tax year, the lower will be the cost of sales for that year and the greater the taxable income of the taxpayer. Conversely, the lower the value attributed to closing stock, the higher the cost of sales and the lower the taxable income for that year. If taxpayers had a free hand in determining the value of trading stock at year end it would open the way for them to obtain a timing advantage in regard to the payment of tax, by adjusting the value of closing stock downwards. They could by adjusting these values manipulate their overall liability for tax in the light of their anticipations in regard to future rates of tax, future trading results, the need to incur significant expenses in the future and the like.

[7] Sections 22(1)(*a*) and (*b*) of the Act are directed at avoiding such manipulation by prescribing the basis upon which taxpayers are to value trading stock at the beginning and end of each year of assessment. The starting point is that trading stock at year end is to be valued at cost price. There are a number of subsidiary rules in regard to the determination of the cost price. Thus, for example, s 22(3) provides that the taxpayer may add to the actual price paid for the goods, the costs incurred in getting them into their current condition and location, and any further costs required to be included in terms of any generally accepted accounting practice approved by the Commissioner. Section 22(5) deals with the problems occasioned by stock being purchased over time and outlaws the use of the 'last in, first out' (LIFO) method of valuation, while leaving

taxpayers to choose among other methods, such as average cost or 'first in, first out' (FIFO).[5]

[8] During the tax years under consideration in this appeal, s 22(1)(a) read as follows:

'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 … has been diminished by reason of damage, deterioration, change of fashion, decrease in the market value or for any other reasons satisfactory to the commissioner . . .'

[9] The dispute in this case is whether the value of Volkswagen's trading stock had diminished entitling the Commissioner to make a just and reasonable allowance under the section. In practical terms, an allowance permits the taxpayer to reflect the value of its trading stock at less than cost price in its tax return. Volkswagen contended that it should be entitled to do this on the basis of the NRV of its trading stock at each of the three year ends from 2008 to 2010. It said that NRV reflected that the value of the trading stock had diminished.

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[5] The use of LIFO serves to arrive at the lowest possible value for trading stock at year end. If used over a period of years it consistently lowers the profits earned each year. According to BC 12 in the Board Commentary to IAS 2 the use of LIFO in financial reporting is usually tax-driven, because it results in a cost of goods sold expense item that reduces profits.

[10] The parties formulated their dispute in a stated case in the following way:

'Whether the NRV of VWSA's trading stock, calculated in accordance with IAS 2 and taking account of the individual categories of costs referred to … above, may and should, where it is lower than the cost price of such trading stock as determined in accordance with section 22(3) of the Act, be accepted as representing the value of trading stock held and not disposed of at the end of the respective years of assessment for purposes of section 22(1)(a) of the Act.'

The categories of costs referred to were described generally as rework/refurbishment costs; outbound logistics; marine insurance; sales incentives; distribution fees; warranty costs, costs relating to the Audi Freeway Plan and the Volkswagen AutoMotion Plan and roadside assistance costs.

[11] Eksteen J reached the following conclusion on this question:

'[37] On a careful consideration of the arguments presented to us I consider that the NRV as set out in IAS 2 is an appropriate method by which to determine the actual value of trading stock in the hands of the taxpayer at the end of the year of assessment. The NRV, determined in this manner must be compared to the cost price, computed in accordance with section 22(3) in order to determine whether a diminution in value has in fact occurred.

…

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

[12] The effect of the judgment was that where the valuation of trading stock at NRV at the close of a fiscal year reflected a value lower than cost price, the Commissioner was obliged to make an allowance for the diminution in value of the trading stock in accordance with s 22(1)(*a*) of the Act.[6] As will be appreciated, this had potentially far-reaching consequences for the Commissioner extending beyond the present case. Under Generally Accepted Accounting Principles in South Africa (GAAP) trading stock at the end of a year must be valued at NRV. If the judgment of the Tax Court was correct then, wherever NRV was less than the cost price of trading stock, the Commissioner would be obliged to permit taxpayers to value trading stock at year end at the lower of cost price or NRV. The question is whether that was consistent with the provisions of s 22(1)(*a*).

Section 22(1)(a)

[13] The starting point in construing the section is the cost price of the trading stock. The manner in which that has to be calculated is dealt with in s 22(3)(*a*). The parties are agreed that in the circumstances of this case, Eksteen J correctly held, that the latter section does not affect the proper interpretation of s 22(1)(*a*). The section empowers the Commissioner to allow a deduction from the cost price, by way of a just and reasonable allowance, in certain circumstances where the value of the trading stock has diminished.

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[6] A similar conclusion was reached in *ITC 13626* para 53. That too involved a taxpayer that was a South African subsidiary of an international group of companies, where the calculation of NRV was undertaken in terms of IAS 2 and the Group's accounting and auditing database entitled 'The Way We Do Things'.

[14] 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. Goods may be damaged in transit and as a result can only be sold at less than cost. Their condition may deteriorate whilst in transit or in storage, as with a cargo of first grade rice undergoing heating at sea, so that it has to be downgraded to second or third grade and is only saleable at less than cost. Fashionable clothing tends to be seasonal and, if not sold before the end of the season, retailers may need to dispose of unsold surplus stock at discounted prices below cost. A decrease in the value of trading stock may arise where stock has been acquired at a particular price and the supplier subsequently reduces the price. For example, a retailer might acquire mobile phones for R400 from the manufacturer. If the manufacturer cuts its price to retailers to R300, in order to get rid of stock before introducing a new model phone, the value of the stock acquired at R400 has diminished.

[15] 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.

[16] The taxpayer is required to determine the value of its trading stock at a particular point in time, namely, the end of the tax year. As is generally the case in determining the taxpayer's taxable income that is an exercise of looking back at what happened during the tax year in question. An important aspect of the language in s 22(1)(*a*) is that the

allowance that the Commissioner may think just and reasonable is 'an amount by which the value of the trading stock has been diminished'. That language is couched in the past tense. The section is accordingly not concerned with what may happen to the trading stock in the future, but with an enquiry as to whether a diminution in its value has occurred at the end of the tax year. All of the instances expressly referred to in the section, namely damage, deterioration, change of fashion and decrease in market value, relate to a diminution of value occurring prior to the taxpayer rendering its return as a result of events occurring prior to that date.

[17] Counsel for SARS submitted that it necessarily followed that there could only be a diminution of value arising from events that had already occurred before the end of the tax year. In other words, the events relied on as demonstrating a diminution in value of the trading stock must have occurred during the tax year, even though their impact might only be felt in the following year. The goods must already have been damaged or have deteriorated in condition. In the case of changes of fashion the change must already have been apparent by the end of the tax year. In the case of a decrease in market value, something must have occurred, such as the catastrophic decline in the price of wool in *Jacobsohn*'s case, to enable the taxpayer to say that the value of the trading stock was now less than its cost price.

[18] There is merit in this submission, although it does not entirely remove the element of futurity from the enquiry. A determination of the current value of goods that have not yet been sold, but will be sold in the future, necessarily involves a measure of prediction in regard to future events. In my view, the correct position is that the Commissioner may

only grant a just and reasonable allowance in respect of a diminution in value of trading stock under s 22(1)(*a*), in two circumstances. The first is where some event has occurred in the tax year in question causing the value of the trading stock to diminish. The second is where it is known with reasonable certainty that an event will occur in the following tax year that will cause the value of the trading stock to diminish. An example might be knowledge that a glut had built up in the market for a perishable commodity, where that glut would ensure a marked, certain and unavoidable decline in the price of that commodity in the following year. Both scenarios are consistent with the basic proposition that the assessment of income tax relates to events that have already occurred rather than events that may occur in the future.

[19] A trading entity that manufactures or acquires goods for resale does so in the expectation that the price it pays to acquire those goods or the costs of manufacture will be less than the price at which it will be able to sell them in due course. The cost price of the goods is therefore not necessarily the value of those goods in the market place. In acquiring or manufacturing the goods in the first place the trader will make allowance for the need to incur expenditure in relation to them in order to be able to sell them at a profit. The expenditure may include expenses in making the goods marketable, for example, rectifying minor damage incurred in transit, packaging the goods, transporting them to the point of sale and the like. Fees and commissions may have to be paid to retailers who will be responsible for selling them directly to the public. Advertising costs may be incurred. In the case of many goods some allowance may have to be made for post-sale remedying of defects. None of these expenses, nor any of the many others that could be envisaged, are relevant to the cost price of the goods. From a taxation perspective they only become relevant once

they have been incurred in seeking to secure the sale of the goods. They will then become 'expenses incurred in the production of income' in terms of s 11(*a*) of the Act and be taken into account in determining the taxpayer's taxable income in the year in which they are incurred.

[20] The cost price of acquiring or manufacturing goods may bear little relationship to the market value of those goods or the price at which the trader proposes to sell them. Yet section 22(1)(*a*) provides that in the ordinary course it is to be the statutory basis for fiscal purposes of establishing the value of trading stock at year end. It is only when the 'value of such trading stock has been diminished' that an allowance may be made. What is meant by this expression?

[21] To read the section as referring to a reduction in the market value of the trading stock, would lead to allowances being claimable for damage, deterioration, change of fashion or decrease in market value even though the trader still fairly anticipated making a profit from the sale of the goods. Returning to an example mentioned earlier, if goods are damaged in transit they may nonetheless be profitably sold as 'slightly shop soiled' or 'slightly damaged'. It would be an absurd reading of the section to permit an allowance in those circumstances and counsel were rightly agreed that only reductions in value below the cost price of the trading stock would justify an exercise of the Commissioner's discretion.

[22] The only way to make sense of the expression 'value of such trading stock' in this context is to accept, as the arguments by counsel effectively did, that it refers to an artificial concept of value represented initially by the cost price of the goods. That is the baseline against which any diminution in the value of the goods must be measured. In turn, it

raises the question of when damage, deterioration, change of fashion, decrease in market value or any other reason may be taken to reduce the value of the goods as reflected in their cost price.

[23] Some guidance can I think be found in the situation in *Jacobsohn*, where a dramatic decline in the future price of wool meant that the wool stocks held by the taxpayer – a trader in wool – were irretrievably devalued.[7] One infers from the judgment that there was no prospect of any revival of the price. Someone wishing to purchase wool in that market would, for the immediate and foreseeable future, have been able to procure it at a price lower than the price paid by Jacobsohn to acquire his stocks. In those circumstances the value of the stocks of wool held by him, when measured against cost price, had been diminished. As a trader he needed to dispose of his stocks, but any endeavour to sell his stocks of wool at prices higher than cost price would certainly be doomed to failure. The effect was that in practical terms he suffered the decline in value of his trading stock in the year prior to that in which the stock would be sold.

[24] The same approach can be applied to the other specified instances leading to a diminution in value of trading stock. A seller of swimwear with a large stock of men's swimming trunks or briefs in fashionable brands, may find it impossible to sell them above cost price, when the trend in male beachwear shifts towards the 'baggies' favoured by surfers. This is not a fanciful example. In the last twenty years the dramatic rise and decline in popularity of Blackberry pagers and Nokia phones may

[7] See fn 3 above. It is unnecessary to consider whether the judgment conflated end of tax year value and future market value, as might be suggested by a passage at 229-230, as the matter is now dealt with legislatively.

conceivably have caused retailers to be left with stock purchased at prices far above those at which the manufacturers were then trying to dispose of the same stock.

[25] Damage and deterioration are directed at the same situation. They only provide grounds for an allowance to be made under s 22(1)(*a*) if the nature of the damage or deterioration is so severe when measured against the cost price that it can be said in common parlance ' the goods are no longer worth that'.

[26] I conclude that on a proper interpretation of s 22(1)(*a*) the cost price of the goods, and not the actual or anticipated market value on their sale, is the benchmark against which any claimed diminution in value is to be measured. A claim for an allowance must be based on events that are known at the end of the tax year for which the allowance is claimed or events that it is known will occur in the following year. There will only be scope for an allowance where the events in question have led to the cost price of the goods ceasing to be a proper measure of their value. In substance, the allowance enables the taxpayer to say that, because of the diminution in value of its trading stock, it has suffered a loss in the current year in the determination of its taxable income and it should be permitted to set off that loss immediately instead of waiting for it to materialise when the goods are sold in a later year.[8]

[27] Volkswagen contended that there had been a reduction in the value of its trading stock 'for another reason'. It did not say that there had been

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[8] The term 'loss' is used here in its generic sense and not in the technical meaning it bears in s 11(*a*) of the Act.

a decrease in market value of its cars. Instead it contended that valuing trading stock at year end, in accordance with NRV and IAS 2, properly reflected a diminution in value of that trading stock and accordingly justified the reduction in value for which it contended. Whether that was so depends upon a consideration of IAS 2, the concept of NRV and its application to the facts of this case. That must then be measured against the provisions of s 22(1)(*a*) in accordance with the interpretation set out above.

IAS 2 and NRV

[28] The International Financial Report Standards (IFRS) are internationally accepted standards issued by the International Accounting Standards Board (IASB). International Accounting Standard 2 (IAS 2) was originally issued in 1993 with revisions being issued in 2003 and 2006. The version with which we are concerned was updated on 2 January 2008. The Accounting Practices Board reissued it in South Africa as AC 108 without alteration and it forms part of the statement of Generally Accepted Accounting Practice (GAAP).

[29] IASB was formed in 2001 as the successor organisation to the International Accounting Standards Committee, which had been setting International Account Standards since 1973. The fundamental objective of IASB, according to its constitution is:

‘to develop, in the public interest, a single set of high-quality, understandable and enforceable global accounting standards that require high-quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world’s capital markets and other users make economic decisions.’

Its predecessor had a similar aim and objective.

[30] This objective was expanded upon in a Conceptual Framework document prepared by the IFRS Foundation, which is the body under which the IASB operates. That document states the second objective in the following terms:

‘The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, members and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.’

The framework document expands upon this. In objective 10 it is said that:

‘Other parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful. However, those reports are not primarily directed to these other groups.’

[31] Annual financial statements prepared in accordance with IFRS, as embodied in GAAP in South Africa, serve a valuable purpose in providing a fair picture to investors, shareholders and creditors of companies about their financial affairs. In doing so, it is important that the picture is fair, both in regard to the past trading activities of the company and also as to its future prospects. It may be more important for those reading the accounts to know that prospects for the year ahead are gloomy, than that the company made substantial profits in the year past. That is why annual financial statements contain many forward looking statements and why IAS 1 on the Presentation of Financial Accounts requires management to make a specific assessment of the entity’s ability to continue as a going concern. The auditor must assess the appropriateness of management’s use of the going concern basis of

accounting and identify any material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern.

[32] Valid though these principles may be for the purposes to which they are directed, they are not necessarily equally applicable to the determination of a taxpayer's liability to income tax in accordance with the provisions of the Act. That is to be determined from year to year and the Act's provisions do not necessarily accord with current accounting principles. Whether the concept of NRV reflects a diminution of value of trading stock for the purposes of s 22(1)(*a*) depends therefore, not on its acceptance as part of GAAP, but on its conformity to the requirements for such a diminution in value as determined on a proper interpretation of that section.

[33] IAS 2 is the prescribed accounting treatment for inventories. These are defined to include all assets held for sale in the ordinary course of business. Net realisable value (NRV) is defined as the estimated selling price of inventory in the ordinary course of business, less the estimated costs of completion and the estimated costs necessary to make the sale. It refers to:

'… the net amount that the entity expects to realise from the sale of the inventory in the ordinary course of business. Fair value reflects the amount for which the same inventory could be exchanged between knowledgeable and willing buyers and sellers in the marketplace. The former is an entity-specific value; the latter is not. Net realisable value for inventories may not equal fair value less costs to sell.'

[34] In terms of clause 9 of IAS 2, inventories shall be measured at the lower of cost or NRV. Detailed provisions are set out in clauses 10 to 18 for the determination of the cost of inventories. These include all costs of

purchase, conversion, and other costs of bringing the inventories to their present location and condition. They do not include storage costs, administrative overheads that do not contribute to bringing the inventories to their present location and condition, or selling costs.

[35] Clause 28 of IAS 2 deals with NRV and explains its purpose. It says that

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

It is unclear whether the final sentence of this clause is applicable only when the value of inventories has fallen as a result of extraneous factors such as damage, obsolescence, a fall in sale prices or an increase in costs, or whether it is more general. In other words, does it require inventories to be written down when there has been no extraneous event, but simply because the entity has made an assessment that contrary to their initial, perhaps optimistic view, they will be unable to dispose of the inventory at a price above cost price?

[36] The determination of NRV is firmly based on the entity’s assessment of future market conditions. Clause 30 says that estimates of NRV are based on the most reliable evidence available at the time the estimates are made of the amount the inventories will realise. Significantly, these estimates take into consideration matters such as fluctuations in price or cost relating to events occurring after the end of the period for which the accounts are being prepared ‘to the extent that

such events confirm conditions existing at the end of the period'. This does not mean that those conditions were anticipated or foreseen at the end of the relevant period. It means that if subsequent events make it clear that at the end of the period the inventory was worth less than cost it should be written down to NRV.

Volkswagen's determination of NRV

[37] Volkswagen classified the items forming part of its NRV calculations as 'Distribution and Selling Costs'. The distribution costs were its rework/refurbishment costs, outbound logistics, marine insurance and distribution fees. The selling costs were sales incentives, warranty costs, costs relating to the Audi Freeway Plan and the Volkswagen AutoMotion Plan and roadside assistance costs. Distribution costs were costs that were anticipated to be incurred between Volkswagen's headquarters in Uitenhage and the various dealerships through which its vehicles would be sold. Selling costs were costs that would be incurred once the vehicles were sold.

[38] The first of these items, 'rework/refurbishment costs', were costs anticipated to be incurred in remedying damage to vehicles forming part of the trading stock so as to put them in a condition for resale. There is no indication whether these costs related to vehicles already damaged at the end of each fiscal year, or whether they were an allowance in expectation that such minor damage would be suffered before the vehicles could be sent to the dealerships. As this item related only to fully built up imports for all three years and to the assembly of trucks and buses in one year, it is likely that at least part of it related to the costs of remedying damage suffered by such vehicles while in transit to South Africa. Such damage

would have occurred prior to the end of the year in which the vehicles were imported.

[39] Outbound logistics represented the costs of transporting vehicles from Volkswagen's distribution yard to dealerships. It related to the actual cost of transporting the vehicle to the dealer and not an unanticipated increase in such costs. In relation to year end trading stock it was a cost that would be incurred when the vehicle was sent to the distributor in the following year.

[40] Distribution fees would also be incurred in the following year. These were fees paid by the taxpayer to its holding company Volkswagen AG under a 'Distribution and Assistance Agreement' that does not form part of the record. These fees were a transfer payment between a subsidiary and its parent company for the sale and distribution rights in relation to Volkswagen and Audi vehicles in South Africa and payment for an unspecified range of support services provided by Volkswagen AG. It is unclear whether they were specific to each vehicle forming part of the trading stock or simply an apportionment of a global fee calculated annually in accordance with the provisions of the Distribution and Assistance Agreement.

[41] All of the other items related to costs to be incurred once the vehicles to which they related were sold. All were estimates of costs 'anticipated to be incurred'. As they would only be incurred once the vehicles were sold it could reasonably be anticipated that they would usually be incurred in the following year, but that would not necessarily be the case. In the case of warranty costs and the Audi Freeway Plan and Volkswagen AutoMtion Plan, whether they would be incurred in the

following year or, a year or more later, would depend upon when the vehicle would be sold and when the costs under the warranty or the two plans would arise. The same is true of roadside assistance costs.

Discussion

[42] It is appropriate to reiterate that the question posed to the Tax Court, and answered affirmatively, was:

‘Whether the NRV of VWSA’s trading stock, calculated in accordance with IAS 2 and taking account of the individual categories of costs referred to … above, may and should, where it is lower than the cost price of such trading stock as determined in accordance with section 22(3) of the Act, be accepted as representing the value of trading stock held and not disposed of at the end of the respective years of assessment for purposes of section 22(1)(a) of the Act.’

Was the Tax Court’s conclusion justified in the light of the construction placed upon s 22(1)(*a*) earlier in this judgment? Expressed differently, does NRV represent the diminished value of trading stock in terms of that section?

[43] There is obvious scope for an overlap between the provisions of s 22(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 s 22(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. A wage settlement at an unexpectedly high level, or an increase in transport costs generated by a fuel price rise or a decline in the value of the

currency, would increase the costs of making sales in due course and have to be taken into account in determining NRV.

[44] With the sole potential exception of some vehicles forming part of Volkswagen's stock in trade having suffered damage requiring refurbishment during the relevant year, all of the items used by Volkswagen in its calculation of NRV were concerned with costs that would be incurred in the future in the sale and distribution of vehicles. Even the extent of any damage requiring refurbishment was anticipated to be minor. The schedule attached to the stated case showed that a modest R525 per vehicle was allowed under this head. There could be no question therefore of the value of trading stock being diminished below cost price as a result of damage to the vehicles constituting such stock. This was a provision to cover minor scratches and dents. No claim for refurbishment was made in respect of used vehicles, which is a further indication that this was a minor item.

[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.

[46] 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 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. In a solvent and profitable trading company it would be surprising if it were not. Companies do not usually acquire, or manufacture, trading stock that they think will realise less than it cost. To pursue that course for any length of time would lead to insolvency. 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 Volkswagen's trading stock as a whole had suffered a diminution in value.

[47] For the purposes of the stated case the Commissioner accepted the correctness of Volkswagen's figures pertaining to its evaluation of NRV. That concession related to the accuracy from an accounting perspective of the calculation of NRV. I do not question that, but if the same approach were transposed to the field of Volkswagen's tax liability, it would leave the Commissioner with little scope for assessing the legitimacy of a calculation relating in its entirety to the future trading circumstances of

the taxpayer. For example, how would he query the assessment of the wholesale selling price when that was a price set by the taxpayer, or possibly in this instance, its holding company? How would he challenge its assessment of the average costs per vehicle of rework/refurbishment or sales incentives? Where the majority of items in a calculation are to be determined by the taxpayer itself, unlike expenses actually incurred, the spectre of manipulation for tax purposes arises. I am not saying that it occurred in the present case, but that possibility is relevant to whether NRV should be accepted as appropriate for adoption in assessing claims for an allowance under s 22(1)(*a*).

[48] Some of the deductions in this case appear to have had a disproportionate effect on the calculation of NRV. The illustrative schedule annexed to the stated case referred to eleven Audi vehicles of varying descriptions. In respect of each one an amount of R29 906 was deducted from the wholesale selling price in respect of the Audi Freeway Plan. In all but one instance, that item alone had the effect of reducing the NRV to a figure below the cost price of the vehicle. In the one exception, the addition of the standard amount allowed in respect of a sales incentive was sufficient to bring the NRV below cost price. Both of these were standard costs to be incurred when selling the vehicle. IAS 2 states that selling costs are not taken into account in determining the cost of inventories. It seems strange therefore that they must be brought into the reckoning when determining NRV for the purpose of departing from cost price as a measure of the value of inventory at year end. Presumably the reason is that shareholders and investors should not be under a misapprehension as to the future prospects of profitable sales. That is significantly different from an assessment of the profitability of the

business in the year that has ended, which is the issue for the purposes of taxation.

[49] Volkswagen's own description of what it was seeking to do in invoking IAS 2 is interesting. This was set out in its notice of objection to the revised assessments. The relevant paragraphs of that notice read as follows:

'3.7.3 Volkswagen valued the relevant trading stock *for financial accounting purposes* in conformity with IAS 2 at the lower of cost or net realisable value. It adopted the same value for the purposes of s 22(1) of the Income Tax Act.

3.7.4 The determination of net realisable value requires an examination not only of the gross amount that will be realised on disposal but also of the costs that will be incurred to make the sale. The rationale is that the trading stock must be valued in the context of the business in which it is held and stated at *the value at which it would be sold in an arm's length disposal of the business*. This value is derived by establishing the net amount that would flow to the business as a consequence of the sale of the trading stock in the normal course. The sale value of the item is reduce by the costs that will be incurred in order to effect the sale. That represents the value that will accrue to the business on realisation of the trading stock.' (Emphasis added.)

[50] The underlying assumption was that what was desirable and necessary from a financial accounting perspective was equally applicable to the entirely different question whether the value of the trading stock at the close of the tax year had been diminished by events occurring during that year. The assessment was of the value of the stock if there were an arm's length disposal of the business. But s 22(1)(*a*) is concerned with the value of the trading stock as trading stock at year end. It is unclear why, from a financial accounting point of view, one would value stock as if the business was being disposed of, especially when dealing with a subsidiary of the largest motor vehicle manufacturer in the world, thereby

rendering the possibility of such a disposal unlikely, but it is plainly irrelevant to the valuation of trading stock for tax purposes.

[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.

[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.

[54] With respect, I think that the learned judge in the Tax Court erred in failing to recognise that s 22(1)(*a*) is not concerned with contrasting cost price with a value determined by 'an appropriate method by which to determine the actual value of trading stock in the hands of the taxpayer at the end of the year of assessment'. In looking for a sensible and businesslike manner of valuation of trading stock at year end he answered a question other than the one posed by the facts and formulated by the parties in the stated case. That question was whether NRV should be used to determine the value of trading stock at year end for the purposes of claiming an allowance against cost price under s 22(1)(*a*). Whether it was a sensible and businesslike manner of valuing trading stock from an accounting perspective was neither here nor there. The concern was whether it accurately reflected the diminution in value of trading stock contemplated in the section.

Result

[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.

[56] In the circumstances the appeal succeeds and the following order is made:

1 The appeal succeeds with costs, such costs to include those consequent upon the employment of two counsel.

2 The order of the Tax Court is set aside and replaced by an order dismissing the appeal and confirming the additional assessments for the 2008, 2009 and 2010 years of assessment.

M J D WALLIS

JUDGE OF APPEAL

Appearances

For appellant:	R G Buchanan SC (with him R J Tsele)
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