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Crowe Perspectives

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Withdrawal of Stock – Tax Risks

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Tax Implications in Relation to Withdrawal of Stock

Companies usually conduct various marketing and promotional activities to promote their products to existing as well as new customers. Due to the competitive business environment, companies may undertake several marketing approaches which include withdrawal of their trading stock as promotional items to be given to their customers. However, companies often overlook the tax implications in relation to their actions in withdrawing trading stock for business usage. Failure to comply with the tax legislation relating to withdrawal of stock may lead to additional tax payable by the companies.

Public Rulings (PR) on Tax Treatment of Stock in Trade

The Inland Revenue Board of Malaysia (IRBM) issued PR 4/2006 - Valuation of Stock in Trade and Work in Progress to highlight the tax implications when a person withdraws stock for own use without any consideration. The PR explained that the difference between the market value of the stock and the cost of the stock will be subject to tax in that particular year of assessment. In an example given in that PR, the stock withdrawn for the sole-proprietor's friend's wedding is taxable pursuant to Paragraph 24(2)(a) of the Income Tax Act, 1967 (ITA) as part of the gross income from the business.

In year 2020, the IRBM issued PR No. 3/2020 - Tax Treatment of Stock in Trade Part II - Withdrawal of Stock to specifically clarify the tax treatment of withdrawal of stock in trade pursuant to Sections 24(2) and 24(3) of the ITA. These PRs have defined stock in trade, whether moveable or immovable, to include the following:

- (a) **property** sold in the ordinary course of the business or would be sold if it were mature or if its manufacture, preparation or construction were complete; or*
- (b) **materials** used in the manufacture, preparation or construction of any such property as referred to in paragraph (a) above and includes any **work in progress**.*

Public Rulings (PR) on Tax Treatment of Stock in Trade (cont'd)

The provisions of the ITA on withdrawal of stock are pursuant to Sections 24(2) and Section 24(3) of the ITA.

Section 24(2) of the ITA [Stock in trade withdrawn]

Where in the relevant period any stock in trade of a business of the relevant person is—

*(a) withdrawn for his own use; or
(b) withdrawn (otherwise than on requisition or compulsory acquisition or in a similar manner) without any consideration being received therefor or for a consideration consisting of—*

*(i) any property not being either a debt owing to the relevant person or a sum in cash or the equivalent of cash;
(ii) any such property together with a debt owing to the relevant person or any such sum; or
(iii) any such property together with a debt owing to the relevant person and any such sum,*

then, subject to subsection (3), an amount equal to the market value of that stock in trade at the time of its withdrawal shall be treated as gross income of the relevant person from the business for the relevant period.

Public Rulings (PR) on Tax Treatment of Stock in Trade (cont'd)

Section 24(3) of the ITA [Consideration for stock in trade withdrawn]

Where in a case to which subsection (2) applies the consideration for the withdrawal of any stock in trade is consideration of the kind described in subparagraph (b)(ii) or (iii) of that subsection, then, for the purposes of that subsection—

(a) the amount of the market value of that stock in trade shall be reduced by the amount of the debt or sum or the amount of the debt and sum, as the case may be, referred to in whichever of those subparagraphs applies to the case;

(b) subsection (1) shall apply to the debt as if it were a debt arising on the sale of that stock in trade; and

(c) section 28 shall apply to any such sum.

Withdrawal of stock is common in the property market. A property developer may transfer his trading stock (i.e. unsold properties) to fixed assets at the cost value. These properties may be rented out to derive rental income. In this scenario, the market value of the properties brought into account as fixed assets shall be treated as gross income of the property developer pursuant to Paragraph 24(2)(b) of the ITA.

Other than the above example, there are a few special scenarios in respect of withdrawal of stock in businesses. The following scenarios may be challenged by the IRBM during a tax audit if the appropriate tax treatment is not adopted.

Stock in Trade used as Demonstration Items

Company A is an auto parts dealer. The Company has selected a few types of auto parts as demonstration items. These items were placed at the lobby of the Company's premises for customers who visit their business premises to view. The cost of auto parts has been taken up as part of the cost of goods sold.

Accounting Treatment:

No sale is recognised for the demonstration items and the stock is still kept in the closing stocks.

Tax Treatment:

The Company is required to account for the auto parts withdrawn from its stock. The difference between the cost value and the market value of the auto parts is treated as taxable income of the business for the relevant year of assessment.

Tax Issues:

From a business perspective, the Company has yet to dispose of the stock. The stock is only used as a sample to promote the Company's products. However, the stock which was used as the demonstration items may be sold eventually. The proceeds from the sale will be recorded in the Company's accounts. Should the gain or loss from the actual sale be brought to tax? Practically, the Company is required to keep records for the deemed sale transaction in order to avoid the same transaction being taxed twice. Nevertheless, the Company may consider treating the demonstration items as used products for future disposal.



Stock in Trade Donated to the Ministry of Health

During the Covid-19 outbreak, Company B donated its products, namely hand gloves to the Ministry of Health as a donation in kind. Hand gloves are one of the items which are in high demand during the outbreak. Although the Company had accounted for the withdrawal of stock in trade at cost, for tax purposes, the Company has to account for the said withdrawal at an amount equal to the market value of the hand gloves and not at cost. The market value of hand gloves is treated as the gross income from the business in the year of assessment pursuant to Paragraph 24(2)(a) of the ITA.



Accounting Treatment:

No sale is recognised for the withdrawal of stock used as donation to the Ministry. However, the cost value of stock donated is charged to the Profit and Loss Account as part of the cost of goods sold.

Tax Treatment:

The market value of the hand gloves is treated as gross income of the business for the relevant year of assessment.

Tax Issues:

The Company has made an approved donation in kind to the Ministry of Health. Since the market value of stock which was donated to the Ministry has been brought to tax, the Company is eligible to claim the approved donation and set-off this against the aggregate income of the Company, but restricted to a 10% threshold. The tax treatment for approved donation is applicable for the cost value of stock.

Stock in Trade Given Away to the Company's Spokespersons

Company C is a famous jewellery manufacturer in town. Other than the normal marketing campaign and promotion activities, the Company also gives away some of its products to selected well known artists (spokespersons). The artists will wear the jewellery to attend public events in town and indirectly promote the jewellery to potential customers who they meet at these events.

The jewellery given will not form part of the remuneration of the artists. Instead service payments for the photo shooting sessions and royalty payments made to the artists will be the payments made for their services rendered. Based on past experience, the Company found that this is one of the most effective marketing strategies to attract potential customers.

Accounting Treatment:

No sale is recognised for the jewellery given away to the selected artists. However, the cost value of the jewellery withdrawn from stock is charged to the Profit and Loss Account as part of the cost of goods sold.

Tax Treatment:

The market value of the jewellery is treated as gross income of the business for the relevant year of assessment.

Tax Issues:

From a business perspective, the stock withdrawn is only used as samples to promote the Company's products. Nevertheless, the IRBM may challenge the deductibility of the cost value of the jewellery given away to third parties as there is no documentation to substantiate the special promotion services rendered by the artists for the Company. In the worst case scenario, the IRBM may treat the withdrawal of stock as a non-approved donation.

Stock in Trade Given to Staff as Uniform

Company D is an Italian luxury fashion company. The Company has selected some newly arrived clothes for their staff to wear in the outlets during working hours. The clothes given to the Company's staff for their use as uniforms are also treated as staff welfare expenses.

Accounting Treatment:

No sale is recognised for the clothing given to the Company's staff as their uniform. However, the cost value of clothing withdrawn from stock is charged to the Profit and Loss Account as part of the cost of goods sold.

Tax Treatment:

The market value of the clothing is treated as gross income of the business for the relevant year of assessment.

Tax Issues:

From a business perspective, the withdrawal of stock is only used as a sample to promote the Company's products. The clothing worn by the Company's employees can serve as promotion to visitors who come to the outlets. At the same time, the uniform provided by the Company is treated as staff benefit to the employees. Hence, it is an expenditure incurred wholly and exclusively for the production of business income. Nevertheless, the IRBM may challenge the deductibility of the cost value of clothing given away to the staff as withdrawal of stock if the market value of stock is not brought to tax.



Stock in Trade Used for Leasing

Company E is in the business of trading and leasing of special machineries. The Company will purchase some of the machineries from time to time when its customers place orders or when there is a potential leasing transaction. All machineries will be initially taken up as stocks when the intention for its use is unclear and reclassified to fixed assets when the customer wants to lease the machinery.



Accounting Treatment:

No sale is recognised for the machineries withdrawn from stock. However, the cost of machineries will be reclassified from stock in trade to fixed assets when the Company has signed the leasing agreement with its customers.

Tax Treatment:

The market value of the machineries is treated as gross income of the business for the relevant year of assessment.

Tax Issues:

From a business perspective, it is difficult for the Company to take up the machineries in the respective business if its customers have yet to decide whether it is an outright sale or leasing of machineries. To prevent customers from transacting with other competitors in the same industry and to increase the Company's market share, the Company always make the machineries available for purchase or lease. However, it appears that the above reclassification of account is regarded as a withdrawal of stock. In this case, the difference between the cost value of the machineries and the market value will be taxable.

Summary

Companies are encouraged to further scrutinise transactions which are similar to the those mentioned above. Please consult your tax consultants if there is ambiguity on the tax treatment of stock withdrawals.

In view of the above potential tax risks, it is advisable for companies to review the tax implications on reclassification of stock in trade.



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Need assistance on these matters?

Please contact us if you wish to seek clarification on any of these issues.

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