

TR 2005/D11 - Income tax: the cost basis of valuing trading stock for taxpayers in the retail and wholesale industries



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Draft Taxation Ruling

Income tax: the cost basis of valuing trading stock for taxpayers in the retail and wholesale industries

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Preamble

*This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVA of the **Taxation Administration Act 1953**. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office.*

What this Ruling is about

Class of person/arrangement

1. This Ruling applies to taxpayers in the retail and wholesale industries who choose to value their trading stock on hand at the end of a year of income at 'cost' for the purposes of section 70-45 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Ruling

2. Where a retailer or wholesaler elects under section 70-45 of the ITAA 1997 to value trading stock on hand at year end at cost, the cost of each item of trading stock includes all direct and indirect expenditure incurred in relation to the item in bringing the item to its 'present location and condition' up to the time that the item is located in its final selling location.

3. This valuation methodology is generally known as absorption costing. Absorption costing requires that freight, insurance and other costs incurred in the normal course of operations in bringing articles of trading stock to their point of sale be added to the invoice cost of the articles to determine their cost.

Date of effect

4. It is proposed that when the final Ruling is issued, it will apply both before and after its date of issue. However, there are two exceptions. The first exception is that the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20). The second exception is for taxpayers who have applied the principles described in this ruling in valuing their closing stock at cost for the year ended 30 June 2004 and have not adjusted their closing stock in earlier returns consistent with Law Administration Practice Statement PS LA 2003/13. It is proposed that the final Ruling will apply to these taxpayers for calculating the cost of closing stock at 30 June 2004 and for subsequent years.

Related rulings

5. The following are related rulings:
- Taxation Ruling IT 2350: Income tax: value of trading stock on hand at end of year: cost price: absorption cost.
 - Taxation Ruling TR 98/2: Income tax: miscellaneous trading stock issues affecting the general mining, petroleum mining and quarrying industries.
 - Taxation Ruling TR 93/29: Income tax: motor vehicle dealers: valuation of stock on hand: motor vehicles traded in.

Explanation

Valuation of trading stock

6. Section 70-45 of the ITAA 1997 provides that a taxpayer may elect to value each item of trading stock on hand at the end of an income year at cost.

Absorption costing

7. Taxpayers in the retail and wholesale industries who value their trading stock on hand at cost should use absorption costing for income tax purposes. The use of absorption costing for income tax purposes is consistent with the accounting treatment of 'production overheads', 'other production costs', 'administrative overheads', and 'other costs' for valuing inventories as prescribed in Accounting Standard AASB 102 (AASB 102). Absorption costing values inventories by including relevant costs 'in bringing the inventories to their present location and condition'. In the case of a retailer or a

wholesaler, this includes the costs of distribution and storage up to the point that the inventories are located in their final selling location.

Cost and cost price

8. Section 70-45 of the ITAA 1997 allows a taxpayer to value 'each item' of trading stock at 'cost'. The corresponding provision in the *Income Tax Assessment Act 1936* (ITAA 1936) allowed a taxpayer to value 'each article' of trading stock at its 'cost price' (subsection 31(1) of the ITAA 1997). 'Cost' and 'cost price' are not defined in either the ITAA 1997 or the ITAA 1936. The change from 'cost price' to 'cost' was made as a simplification measure and did not intend any change in meaning: refer to the Explanatory Memorandum to the Tax Law Improvement Bill 1997. Given this and the application of section 1-3 of the ITAA 1997, the principles that previously applied in determining the 'cost price' of an article of trading stock for the purposes of the ITAA 1936 continue to apply in determining the 'cost' of an item of trading stock for the purposes of the ITAA 1997.

Commercial principles and accounting conventions – decided cases

9. In the absence of statutory definitions of 'cost' and 'cost price', the Board of Review and the courts have applied commercial principles and accounting conventions in a number of cases in an income tax context, including how the cost of trading stock should be calculated. In *FC of T v. St Hubert's Island Pty Ltd* (in liq) 78 ATC 4104; (1978) 8 ATR 452, Mason J stated (at 78 ATC 113; 8 ATR 462):

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

10. In *Case 19* (1946) 12 TBRD (OS) 128; (1946) 12 CTBR *Case 19*, the Board of Review decided that the trading stock of an importer of petroleum products should be valued by adding to the invoice price the direct costs incurred in having the trading stock delivered to the taxpayer's premises. Whilst recognising that cost price was probably not susceptible of precise definition, the Board of Review adopted the meaning of cost as generally understood in an accounting sense.

11. In *Philip Morris Ltd v. FC of T* 79 ATC 4355; (1979) 10 ATR 44 (*Philip Morris*), the taxpayer had valued its manufactured trading stock using a direct costing method. Under this approach, the costs ascribed to the trading stock consisted only of the costs of materials and the wages of those employees who moved or performed operations on those materials in the course of the manufacturing process.

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12. Variable production overheads were included by agreement between the parties as part of the cost of trading stock prior to the hearing. These are costs of production which vary directly with the volume of production, for example, factory light and power.

13. In its decision, which was considering the cost of trading stock up to the completion of the manufacturing process, the Court focused on the treatment of fixed factory overhead costs, that is, costs of production that remain relatively constant from financial period to financial period irrespective of variations, within normal operating limits, in the volume of production. Examples are rent, insurance, property taxes, depreciation and supervisory salaries.

14. In *Phillip Morris* at 79 ATC 4357; 10 ATR 48 the Court assumed

that the legal conception of what is required, or permitted, by subsection 31(1) when a manufacturer exercises his option to value an article of trading stock at cost may be enlarged or varied by proof of relevant changes in accounting principle or practice

and held that a proportion of fixed factory overhead costs had to be included as part of the cost of trading stock because the statutory meaning of cost price in subsection 31(1) of the ITAA 1936 was its actual or true cost.

15. The Court rejected the direct costing method on the basis that it produced a value for cost that was a measure of the gains of the business rather than a value that accurately reflected what the article of trading stock had cost the manufacturer to make.

16. *FC of T v. Kurts Development Limited* 98 ATC 4877; (1998) 39 ATR 493 (*Kurts*) also involved the value of trading stock on hand for the purposes of the ITAA 1936 where the taxpayer had valued its trading stock at its cost price. The taxpayer was a land developer who purchased land in the form of broadacres and converted the broadacres into subdivided blocks. The land was trading stock of the taxpayer. The taxpayer also incurred certain indirect costs for works on nearby public land and structures not owned by the taxpayer to assist in the provision of the services to the taxpayer's subdivided lots, and for other work done by the local authority in relation to the subdivision.

17. The Full Federal Court decided that the indirect costs associated with the provision of the infrastructure and the external costs had to be absorbed in determining the cost of the trading stock for the purposes of subsection 31(1) of the ITAA 1936.

18. Although the *Philip Morris* and *Kurts* cases are not directly relevant to retailers and wholesalers, they do assist in clarifying the valuation principles for taxpayers generally, including taxpayers in the retail and wholesale industries. For example, the taxpayer in the *Philip Morris* case was a manufacturer and, as noted at paragraph 13, the issue before the Court was the cost of trading stock up to the completion of the manufacturing process. It may be accepted that the trading stock of a manufacturer which does not also act as a distributor, a retailer or a wholesaler is located in its final selling location at the

completion of the manufacturing operation, and that costs should be absorbed until that time. The trading stock of retailers and wholesalers is located in its final selling location after the completion of any distribution and storage operations undertaken in connection with the trading stock. As retailers and wholesalers are required to absorb costs until their trading stock is in its final selling location, the costs to be absorbed by them include the costs of distribution and storage.

Commercial principles and accounting conventions – Accounting Standards

19. The application of absorption costing accords with accepted industry practice, AASB 102, and International Accounting Standard IAS 2. In particular, sections 10 and 15 of AASB 102 require that particular costs 'in bringing the inventories to their present location and condition' be included in determining the cost of the inventories for inventory valuation purposes.

20. AASB 102 applies to annual reporting periods beginning on or after 1 January 2005 and supersedes Accounting Standard AASB 1019 (AASB 1019) which applies to annual reporting periods beginning before 1 January 2005. There is no material difference between AASB 102 and AASB 1019 in relation to the application of absorption costing principles to retailers and wholesalers.

Interaction between accounting principles and the term 'cost' as used in the trading stock provisions

21. The value of a taxpayer's trading stock in its financial accounts is not necessarily its value for taxation purposes. The income tax assessment process requires the determination of a taxpayer's taxable income for the purposes of the ITAA 1997 and the ITAA 1936. The object of the financial accounts is to provide a true and fair view of the financial position for the purposes of disclosure. The financial accounts are prepared through the application of generally acceptable accounting principles and compliance with accounting standards.

22. A difference between the financial accounts and the determination of taxable income can arise, for example, through the use of different trading stock valuation methodologies. Inventories may be recorded in the financial accounts at either their 'cost' or their 'net realisable value'. Neither the ITAA 1997 nor the ITAA 1936 permits a taxpayer to value articles of trading stock at their 'net realisable value'. Similarly the ITAA 1997 and the ITAA 1936 allow other bases of valuation which are not permitted under AASB 102 including market selling value and replacement value (although AASB 102 allows a not-for-profit entity to value inventories held for distribution at current replacement cost).

Absorption costing – elements to be absorbed for taxpayers in the retail and wholesale industries

23. Typically, full absorption costing would require the following costs to be absorbed into the value of trading stock on hand at year end:

- the purchasing function;
- operating distribution centres;
- operating warehouses or storage areas not forming part of the selling location;
- freight from the supplier's premises to the retailer's or wholesaler's warehouse or distribution centre; and
- freight from the retailer's warehouse or distribution centre to the retail outlet.

24. Typically, the costs of operating a warehouse or distribution centre would include:

- employees' remuneration;
- light and power;
- cleaning;
- security;
- repairs and maintenance;
- freight;
- insurance;
- rent;
- rates and taxes;
- lease costs;
- depreciation;
- telephone;
- workcare premiums;
- superannuation; and
- other administration costs.

25. Examples of costs not taken into account in valuing trading stock on hand under the principle of absorption costing are:

- general administrative costs unrelated to the operation of the warehouse or distribution centre;
- costs connected with the selling function;
- costs incurred outside the normal operations of the warehouse or distribution centre;

- costs of carrying obsolete stock;
- cost of displaying goods in the retail outlet;
- cost of transporting goods from the selling location to the customer's premises;
- interest; and
- advertising.

Materiality

26. In practice, incidental costs of a minor nature which may be time consuming to record and would not result in material differences in the value of trading stock need not be taken into account.

27. Taxpayers with a gross operating turnover of less than \$10 million may make an appropriate estimate of the additional costs to be absorbed which need not be based on detailed records of all expenses. For example, an accurate calculation of costs for a month might be used to estimate the annual costs to be absorbed.

28. STS taxpayers who elect to participate in the simplified tax system only need to account for changes in the tax value of their trading stock if there is a difference of more than \$5,000 in the tax value of their stock on hand at the start of the income year and a reasonable estimate of the tax value of all their stock on hand at the end of the income year. If the difference is \$5,000 or less, the value of closing trading stock will be equal to the value of opening stock for income tax purposes.

Your comments

29. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date.

Due date:	7 October 2005
Contact Officer:	Gerard Chandler
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Detailed contents list

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Previous draft:

Not previously issued as a draft

*Related Rulings/Determinations:*IT 2350; TR 92/20; TR 93/29;
TR 98/2*Subject References:*

- cost
- trading stock
- trading stock valuation

Legislative references:

- ITAA 1936 6(1)
- ITAA 1936 31(1)
- ITAA 1997 1-3
- ITAA 1997 70-45
- TAA 1953 Pt IVA

Case references:

- Case 19 (1946) 12 TBRD (OS)
- 128; (1946) 12 CTBR Case 19

- FC of T v. Kurts Development
Limited 98 ATC 4877; (1998)
39 ATR 493

- FC of T v. St Hubert's Island Pty
Ltd (in liq) 78 ATC 4104; (1978) 8
ATR 452

- Philip Morris Ltd v. FC of T 79
ATC 4355; (1979) 10 ATR 44

Other references

- Explanatory Memorandum to the
Tax Law Improvement Bill 1997
- Law Administration Practice
Statement PS LA 2003/13
- Accounting Standard AASB 102
- Accounting Standard AASB 1019
- International Accounting Standard
IAS 2

ATO references

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