



Taxation Ruling

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

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① This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

What this Ruling is about

Class of entities/scheme

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 subsection 70-45(1) of the *Income Tax Assessment Act 1997* (ITAA 1997).

Related Rulings

2. 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.

Ruling

3. Where a retailer or wholesaler elects under subsection 70-45(1) 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.

4. 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 items of trading stock to their point of sale be added to the invoice cost (net of GST input tax credits and any other recoverable taxes and duties) of the items to determine their cost.

Date of effect

5. This Ruling applies to years of income both before and after the date of issue. However, there are three 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. 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 subsequent years following the issue of Law Administration Practice Statement PS LA 2003/13. The Practice Statement indicated that these taxpayers were not required to make adjustments for earlier years of income. Accordingly, this Ruling only applies to these taxpayers for calculating the cost of closing stock at 30 June 2004 and for subsequent years. The third exception is for taxpayers and consolidated groups with an annual gross operating turnover of less than \$10 million. Provided their returns of income for the 2005 and earlier years evidence a reasonable and practical basis to correctly bring to account their trading stock (see paragraph 1 of PS LA 2003/13), this Ruling applies to them, and in the manner described in paragraphs 27 to 30 of this Ruling, to years of income ending after its date of issue.

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

Valuation of trading stock – cost and cost price

6. Subsection 70-45(1) of the ITAA 1997 allows a taxpayer to value 'each item' of trading stock on hand at the end of an income year 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 1936). '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.

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. Under absorption costing, the costs to be absorbed for income tax purposes include the cost of purchase and any direct or indirect expenses incurred in relation to the trading stock in the normal course of operations in bringing the trading stock to a saleable condition and to its existing location. In a retail or wholesale business, these include:

- the purchase price;
- import duties and taxes (other than those subsequently recoverable from tax authorities, such as GST);
- inwards transport and handling charges;
- insurance on the trading stock while in transit;
- adjustments and assembly costs incurred in preparing the trading stock for sale;
- relevant costs incurred in operating a purchasing department; and
- administrative costs associated with receiving and inspecting the trading stock.

In addition, distribution centre and off-site storage costs should be apportioned across the relevant trading stock.

Commercial principles and accounting conventions – decided cases

8. 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 ...

9. 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.

10. 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.

11. 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.

12. 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.

13. In *Philip 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.

14. 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.

15. *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.

16. 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.

17. Although the *Philip Morris* and *Kurts* cases did not deal with 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 12 of this Ruling, 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. Accordingly, for the purposes of a full absorption costing calculation, retailers and wholesalers would be required to absorb costs until their trading stock is in its final selling location, for example on a retail outlet shelf or a wholesale outlet shelf.

Commercial principles and accounting conventions – Accounting Standards

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

19. AASB 102 applies to annual reporting periods beginning on or after 1 January 2005 and supersedes Australian Accounting Standard AASB 1019 (AASB 1019) which applied 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

20. 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.

21. Use of absorption costing for inventories in accordance with AASB 102 would often produce an acceptable value of the cost of trading stock for taxation purposes. However, differences may arise. For example, as general accounting standards are concerned with accounting concepts of profits or gains and not assessable income, some non-deductible costs that are absorbed for accounting purposes, such as provision for holiday pay, are not relevant for the calculation of cost of trading stock for income tax purposes.

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 two other bases of valuation which are not permitted under AASB 102, namely 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 purchase price;
- all costs incurred to the extent they are directly related to the purchase of the trading stock;
- 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 selling outlet, 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, offsite storage area or distribution centre would include the following costs to the extent they relate to storage and handling of the trading stock:

- 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. Trading stock sold directly to customers from the warehouse or storage location is located in its final selling location and no further costs need to be absorbed in the calculation of the cost of such trading stock once it is located in the warehouse or storage location. In situations where the warehouse or storage location is partly used as a selling location and partly as a storage location, an apportionment of relevant costs would be required. The basis of apportionment is a matter of fact and a fair and reasonable basis would be acceptable.

26. 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

27. 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.

28. Taxpayers and consolidated groups¹ with an annual 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. Similarly, total annual costs may be apportioned against the trading stock at year end taking into account the turnover of the stock.

29. Alternatively, taxpayers and consolidated groups with an annual gross operating turnover of less than \$10 million may calculate the cost of trading stock at year end by adding to the invoice or purchase price of the trading stock other amounts payable in acquiring the trading stock. This may include transport, insurance and other costs ordinarily incurred at the time of purchase. For ease of calculation, taxpayers may use the amounts payable in respect of the most recent units of trading stock acquired to calculate the cost of the trading stock on hand at year end.

30. STS² 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 between 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.

¹ Part 3-90 of the ITAA 1997.

² Subdivision 328-F of the ITAA 1997.

Appendix 2 – Alternative view

31. For retailers and wholesalers the absorption costing calculation of the value of trading stock only includes expenditure incurred in the course of bringing the trading stock to the point in which it first becomes part of trading stock on hand. This view is based on the following extract from the *Philip Morris* decision (at ATC 4360; ATR 52):

The concept expressed by the words 'cost price' in sec.31(1) in my opinion is, in its application to an article of trading stock manufactured by a taxpayer, directed to ascertainment of the expenditure which has been incurred by the taxpayer, in the course of his materials purchasing and manufacturing activities, to bring the article to the state in which it was when it became part of the trading stock on hand.

32. It has been suggested that the Court was saying that relevant costs should be absorbed until an item of trading stock becomes part of trading stock on hand and not after an item of trading stock becomes part of trading stock on hand. The Commissioner does not accept this view because the Court was dealing with the calculation of the cost of manufactured articles at the time that the manufacturing process has been completed and the articles became 'part of...trading stock on hand.' The Court went on to say (*ibid*) that:

...the ascertainment of expenditure referable to one of very many identical manufactured articles is, I think, ordinarily to be achieved by allocating to each of the articles manufactured during a year an equal share of the year's expenditure incurred in manufacturing them all.

Appendix 3 – Detailed contents list

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References

Previous draft:

TR 2005/D11

Related Rulings:

IT 2350; TR 98/2; TR 93/29

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(1)
- ITAA 1997 70-45(1)
- ITAA 1997 Subdiv 328-F
- ITAA 1997 Pt 3-90
- TAA 1953

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:

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

ATO references

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