


TR 93/D11 - Income tax: use of the absorption costing method of valuing trading stock at cost price with reference to the mining industry

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Draft Taxation Ruling

Income tax: use of the absorption costing method of valuing trading stock at cost price with reference to the mining industry

other Rulings on this topic

IT 2350, IT 2001, TR 93/3

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What this Ruling is about

1. This Ruling discusses the application of the absorption costing method of valuing the cost of trading stock on hand for purposes of section 31 of the *Income Tax Assessment Act 1936*. While it has general application, it is specifically directed to the mining industry. In particular, the Ruling deals with:

- (i) which costs relate to production and therefore must be absorbed
- (ii) how costs are to be apportioned between production and other purposes
- (iii) at what rate costs are to be absorbed.

2. To some extent, this Ruling has reviewed certain parts of Taxation Ruling IT 2350 which broadly sets out the view supported by the courts that the absorption costing method is the correct method to determine the cost price of trading stock on hand.

Ruling

Which costs relate to production and therefore must be absorbed?

3. In some cases, it is clear which expenses relate to production. However, in every case it will be necessary to consider individual circumstances as to whether a cost was a cost of production at all,

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whether the costs relate to a stage of production that the particular stock on hand has not yet reached or whether the expense incurred relates to a time after the completion of the production process.

4. The expenditures which are part of the costs of trading stock on hand include both fixed and variable costs. Those costs may be classified in many ways. In IT 2350, costs were classified as material costs, costs of direct labour, and production overheads - the latter including both variable and fixed elements.

5. Taxation Ruling TR 93/3 explains that for taxpayers in the business of mining, the ore is regarded as trading stock on hand as soon as it is severed from the ground. Trading stock will therefore exist throughout all later stages of production.

6. As a general rule, mining costs that *are* to be absorbed include:

- (i) employee benefits relating to production employees.
This Ruling departs from IT 2350 in this regard.
- (ii) costs of transport to and between production processes, such as crushing, washing and blending.
- (iii) depreciation/amortisation of capital expenditure.
- (iv) costs of washing ore.

7. Costs that *are not* generally to be absorbed include:

- (i) exploration and prospecting.
- (ii) storage and distribution other than in the course of production.

How costs between production and other purposes should be apportioned

8. In some cases, the expenditure involved may serve more than just production purposes. Only costs relating to production are to be absorbed. The amount of this portion will depend on the facts in each case. The most appropriate basis of apportionment is a matter of fact, and the ATO will accept a fair and reasonable basis put forward by a taxpayer. Different bases of apportionment include: time (e.g., in machine hours or usage), number of employees, volume, weight or value. For example to apportion township costs the following formula could be used:

$$\frac{\text{total production workforce and their supported families resident in town}}{\text{total town population}} \times \text{costs}$$

At what rate are costs to be absorbed?

9. Capital expenditure should be absorbed over no more than the number of years that the expenditure relates to the production of trading stock, i.e., useful life - as with depreciation. For example, if a machine purchased is expected to be used for 8 years, it must be absorbed over no more than 8 years. Capital expenditure is written off at the rate used in the taxpayer's accounts (provided that rate is calculated in accordance with Australian Accounting Standards) or at the rate calculated in accordance with the Income Tax Assessment Act and used in the tax calculations of the taxpayer (for purposes of other provisions of the Act).

10. It is not possible to have different effective life estimates for depreciation and costing purposes. In a similar way, the same estimate of effective life should be used to work out both opening and closing stock values. The amount amortised for costing purposes when using accounting rates should not be adjusted where asset revaluations are made.

Date of effect

11. This Ruling generally applies to years commencing both before and after its date of issue. However, to the extent that it involves a change in interpretation that is less favourable to taxpayers than our previous practice, it will apply from the date of issue in respect of that specific change of interpretation. Moreover, this Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a 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).

Explanations**What costs relate to production and therefore must be absorbed?**

12. Trading stock is defined in subsection 6(1) to include "anything produced, manufactured, acquired or purchased for purposes of manufacture, sale or exchange...". In TR 93/3, it was noted that the term "trading stock" also includes work in progress. As explained in IT 2350 paragraph 7, there are three elements to be taken into account in determining the cost of trading stock produced by a taxpayer: raw materials, direct labour, and production overheads (fixed and variable).

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13. This view is further expressed by Jenkinson J in *Philip Morris Ltd v. F.C. of T* 79 ATC 4353 at 4360 "'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 his trading stock on hand.' (Jenkinson's reference to manufacture rather than production is natural in a case clearly concerned with a manufacturer).

14. Accordingly, costs in producing the raw materials into finished goods must be absorbed. What costs must be absorbed as part of the cost price of trading stock will be a matter of fact. As a guide, it may be useful to consider whether incurring the expenditure will contribute towards the production of the raw materials into the final product, whether it is preliminary to the production process, and whether it is directed to activities that occur after the production process.

15. In *12 CTBR Case 19* at 341 it was said that 'it is recognised that "cost price" is probably not susceptible of precise definition but we think that it is meant to cover the costs which the taxpayer had borne in acquiring his stock and bringing it to the place at which it was located at the end of the accounting period.'

Storage and distribution costs

16. For this reason costs such as storage and distribution should not be included where they cannot be considered part of the production process but occur after production. Costs which are part of the production process for a miner include, for example, costs of creating an emergency stockpile for loading. In *IT 2001 (Winemakers - valuation of wine stocks)* we have already said that costs of storage is not part of the costs of stocks except in limited cases where the storage will play a part in obtaining the finished product (e.g., for maturation of some types of wine and brandy).

Mineral transport costs

17. Transport cost of minerals from the mine to the port is generally to be absorbed into the cost price of stock on hand at the port. This is a cost of bringing the trading stock 'on hand' at the end of the accounting period as illustrated in *12 CTBR Case 19*. This is so when the port is the place at which the trading stock is ready for sale, and especially when a miner's operations at the port involves blending different grades of ore which is another stage in the production process, or may involve further processing of other kinds.

Exploration and prospecting costs

18. Exploration and prospecting expenditure is incurred too soon to qualify as a production overhead, and therefore should not be absorbed into cost price. While it is necessary before production it is not part of the process.

Coal washing costs

19. Coal washing costs are absorbed because washing forms part of the production process in getting the product into the state in which it is ready for sale.

Employee benefits

20. Employee benefits relating to production employees are considered to be in the same light as indirect and direct labour that is, part of the production process. This means that benefits including cafeteria running costs, first aid and township costs should be absorbed into the cost of production. This is a change in interpretation from paragraph 13 of IT 2350 where it was considered that such employee benefits were not to be absorbed.

21. Paragraph 7 of IT 2350 provides that costs of direct labour are to be taken into the cost of trading stock along with direct materials and overhead costs. This is defined as 'costs of labour directly in the manufacture operations'. Therefore the test for absorption of labour costs (both direct and indirect) will rest on whether the labour was directly related to production not whether the cost was an indirect cost as opposed to a direct salary cost.

22. Employee benefits are directly incurred in connection with the employment of the direct labour. Such benefits are of the same nature as payments made to employees for sick pay, tea money and holiday pay which were held to be included in the cost price under the absorption costing method in the *Philip Morris* case "as if the payments had been made on account of wages earned by that employee in that year of income. Payments on account of payroll tax ought, I think, to be similarly treated." (at 4362)

23. However, it is noted that in some cases such costs will need to be apportioned between production and non-production employees. For example, costs relating to employee benefits of general administrative and sales staff are not indirectly or directly related to production and therefore should not be absorbed into the cost of trading stock.

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Special tax concessions

24. Paragraph 12 of IT 2350 noted that some tax concessions are not expenditures to be absorbed in valuing trading stock at cost. These include such deductions in excess of expenditure as investment allowance, development allowance, and any premium above 100% deductibility for a taxpayer's research and development expenditure. They are not to be absorbed not because the rate of absorption is not appropriate, but because they are not costs relating to production. They are not costs at all.

25. The same paragraph also discusses accelerated tax depreciation rates. The expenditure on depreciable plant is a cost, and must be absorbed at an appropriate rate. But IT 2350 recognises that a concessional accelerated rate could overstate the cost of trading stock produced in early years, and understate the cost of trading stock produced after expenditure had been fully absorbed at the concessional rate, but still relating to that expenditure. See the further discussion on the rate of absorption of costs, below.

Apportioning costs between production and non production purposes

26. Where costs are attributable to both production and non production purposes, it is necessary to apportion such costs so that only costs directed to production purposes are absorbed into the cost of trading stock. Further apportionment is required to allocate overhead costs between work in progress and finished goods that form the trading stock on hand at the end of the income year.

27. In IT 2001, we said that the basis of apportionment is a matter of fact and any fair and reasonable basis would be acceptable. As explained in *12 CTBR Case 19* (paragraph 22): 'What is the best basis of apportionment must depend on the circumstances of the case. In the illustrative case of the joint transport charge, I should think that as a general rule, the most logical apportionment would be on the basis of volume or weight rather than nature or value, although it would be easy to conceive of circumstances in which value would be the predominant factor of the charge and therefore the soundest basis of apportionment.' (Gibson, Chairman)

28. Therefore the basis of apportionment will be a matter to consider in each case as to what is the most appropriate. In the case of depreciation of capital equipment, it may be appropriate to apportion on the basis of time. Transport costs could be apportioned on the

basis of time used, kilometres travelled or proportion of load carried (by weight or volume, as appropriate).

29. Employee benefits shared between production staff and other staff (e.g., cafeteria) would be best apportioned on the basis of relative numbers of employees.

At what rate costs are to be absorbed

30. Expenditure must be absorbed at a rate which effectively links it to the trading stock to which it relates. For many costs, that rate requires immediate absorption - the expenditure is related to immediate production. For other costs, the expenditure may relate to production of trading stock over a period. The *Philip Morris* and *Australasian Jam* cases show that such expenditures must be absorbed at the rate which most appropriately apportions the expenditure over the period in which it will relate to the production of trading stock (which includes work in progress).

31. Some expenditure will be written off for income tax purposes at a particular rate, and may be written off for other accounting purposes at a different rate. Taxpayers might also seek to adopt yet another rate of absorption of expenditure, with effects on the valuation of their trading stock.

32. Accounting standards (AAS4) require that costs be amortised over the period for which the expenditure is expected to contribute to productivity. That rate of absorption, if the taxpayer uses a rate complying with the standards for accounting purposes, is acceptable in valuing trading stock at cost.

33. The income tax law may allow deduction of particular expenditure over a period for income tax purposes. Some such expenditures may be deductible over a shorter period than the period which they will contribute to production. For example, depreciation rates may be given at concessional rates. Divisions 10 and 10AA may give income tax deductions over less than the life of a particular operation, because of the option of ten-year write-off for longer lived mines (twenty-year write-off for longer lived quarries). Division 10AAA may give an accelerated write-off for some mineral transport infrastructure.

34. Paragraph 12 of IT2350 acknowledged that taxpayers need not use tax rates of absorption in such cases. However, it did not discuss the rate of absorption to be used instead.

35. Taxpayers may absorb particular expenditure in valuing trading stock at cost at a rate consistent with the accounting standards and used by the taxpayer in their general accounts, or at a rate consistent

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with the deductions claimed for income tax purposes by the taxpayer. Rates of absorption consistent with neither the accounting standards nor the taxpayer's income tax deductions may not be used.

36. The effect of valuing trading stock at cost is broadly, to defer expenditures relating to the production of that stock until it is disposed of. The tax law does not seek to overstate or understate that deferral. When the accounting standards spread expenditure over the production to which it relates, this represents the taxpayer's best estimate of the basis of absorption. So there could be an argument that only accounts in accordance with the accounting standards could provide the basis of absorption of longer term production expenditures. Obviously, this argument is not compatible with a taxpayer preparing accounts and spreading expenditure over a different period to that required by the accounting standards.

37. However, the value of trading stock on hand is included in assessable income. To value that trading stock at cost in accordance with the accounting standards could lead to an overstatement or understatement of income, compared with the tax deductions for expenditure incurred that relate to the trading stock. So there could be an argument that expenditure must always be absorbed in accordance with the rate of deductions claimed for that expenditure for income tax purposes. Obviously, this argument is not compatible with different tax deduction rates being used for valuing trading stock at cost and for claiming the tax deductions, although a taxpayer may have options as to the rate at which particular deductions are claimed in particular circumstances; for instance, by choosing between prime cost and diminishing value methods of depreciation.

38. In considering the absorption of particular expenditure, the ATO will accept either method. Expenditure may be absorbed on the basis used in the taxpayers accounts, if prepared according to the accounting standards. Or expenditure may be absorbed in accordance with the income tax deductions of that expenditure claimed by the taxpayer. But the ATO does not accept that there is some other option open to the taxpayer. If the taxpayer is following the accounting standards, there is only one proper estimate of the rate at which expenditure contributes to production. If the taxpayer follows the income tax deductions absorbed into trading stock, the deductions to be considered are those the taxpayer claims.

39. The taxpayer is not required to choose the method of absorption that will result in the lowest, or the highest, immediate value of trading stock.

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- Australasian Jam Co. Pty Ltd v.
FC of T (1953) CLR 23
- 12 CTBR Case 19
- Philip Morris Ltd. v. FC of T
79 ATC 4355; 10 ATR 44