


TR 95/D15 - Income tax: property development: valuing land held as trading stock at cost price

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Draft Taxation Ruling

Income tax: property development: valuing land held as trading stock at cost price

other Rulings on this topic

IT 2350; TR 92/3; TR 92/4;
TD 92/126; TD 92/127;
TD 92/128; TD 92/132;
TD 92/161

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Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office.

DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings which represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling. Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office.

What this Ruling is about

Class of person/arrangement

1. This Ruling applies to taxpayers who acquire land as trading stock for the purpose of developing, subdividing and selling the land.
2. This Ruling is about the valuation of land where that land is trading stock on hand at the end of a year of income and the taxpayer values the land at cost price under subsection 31(1) of the *Income Tax Assessment Act 1936* ('the Act'). The Ruling considers the taxation treatment of expenditure incurred in converting such land into the condition in which it is intended to be sold. In particular, the Ruling considers:
 - what expenditure forms part of the cost price of trading stock on hand; and
 - the method of allocating development costs to trading stock on hand, including the situation where land is developed in stages.
3. This Ruling does not deal with situations where the land is not acquired originally as trading stock, or where trading activities have ceased. Some of these situations are dealt with in Taxation Determinations TD 92/126, TD 92/127, TD 92/128 and TD 92/161. The taxation treatment of a profit or loss arising from an isolated transaction is dealt with in Taxation Rulings TR 92/3 and TR 92/4 respectively.

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Ruling

4. The trading stock provisions apply to a taxpayer in relation to land that is:

- acquired or purchased for the purpose of sale or exchange;
- an asset of a business of trading in property of that kind; and
- acquired in the course of carrying on a business that involves trading in property of that kind.

5. Where these conditions are satisfied, a taxpayer must account for the land, for taxation purposes, in accordance with the trading stock provisions, and cannot account for the land on a 'net profit' basis.

6. The trading stock provisions will apply irrespective of whether the taxpayer has carried on the business of trading in land previously. For example, where a company has been incorporated specifically to acquire a particular tract of land for the purpose of development, subdivision and sale, the trading stock provisions will apply.

7. Where broadacres acquired by a taxpayer who is a land developer are comprised of land on separate titles, each separate title is an article of trading stock and must be valued accordingly. Upon registration of a subdivision plan by the appropriate authority (e.g., Registrar of Titles), a separate title is created for each of the subdivided allotments. The original articles of trading stock have been converted into subdivided lots, and each subdivided lot then becomes an article of trading stock of the taxpayer.

Calculating cost price of trading stock on hand

8. Where a taxpayer values trading stock at cost price, the cost of acquiring the land and the costs of development related specifically to converting the land into the condition in which it is to be sold represent the cost price of the trading stock for the purposes of subsection 31(1) of the Act (see *Philip Morris Ltd v. FC of T* 79 ATC 4352; (1979) 10 ATR 44).

9. As a general proposition, administration costs are not related specifically to converting the land into the condition in which it is to be sold and, therefore, are deductible in the year in which they are incurred, but do not form part of the cost price of land acquired as trading stock. However, if certain administration expenses are directly attributable to a particular development project (e.g., the cost of an on-site office), they should be treated as a cost of that project and taken

into account in determining the cost price of the trading stock on hand at the end of the year of income.

10. Similarly, holding costs, such as rates and taxes, or interest on borrowings to acquire or develop the property, are not considered to be part of the cost of converting the land into the condition in which it will be sold and, therefore, do not form part of the cost price of land held as trading stock. They are deductible in the year in which they are incurred, but are not taken into account in determining the cost price of the trading stock on hand at the end of the year of income.

Land dedicated to special uses

11. Generally, an approval for subdivision is conditional upon certain areas of the land being dedicated for special uses, such as roads and reserves. Title in that land usually will vest in either the Crown or local government authority. The costs of acquiring and developing the land so dedicated form part of the cost price of the taxpayer's trading stock. It is part of the cost associated with converting the land into the condition in which it will be sold.

12. In calculating the cost price of trading stock on hand, the cost of acquiring the whole of the land and the cost of developing that land in accordance with the requirements of the approving authority are absorbed into the cost of trading stock. Upon registration of the plan of subdivision, these costs are reallocated to the individual items of trading stock created (the subdivided lots).

13. The vesting in the Crown or other body of the areas of land dedicated to special uses is not regarded as a disposal of trading stock for the purposes of the trading stock provisions. Generally, the taxpayer does not, at any time, hold the land that is so dedicated as separate articles of trading stock.

Electricity Deposits

14. Where a developer is required to lodge a refundable deposit/bond with an electricity authority in relation to the supply of electricity to a residential subdivision, the amount lodged by the developer is an outgoing of a capital nature. Similarly, when all or part of that deposit/bond is refunded to the developer, it is a receipt of a capital nature.

15. If the electricity authority is authorised to retain any part of the deposit/bond lodged by the developer, the amount retained will be deductible to the developer in the year of income in which the authority becomes entitled to retain that amount. This outgoing is not

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regarded as part of the cost of converting the land into the condition in which it will be sold. Accordingly, it is not absorbed into the cost of trading stock on hand.

16. Where the authority is required to pay interest on the deposit/bond, the developer will be assessable in the year of income in which that interest is actually paid or credited to the developer.

17. Where an electricity authority charges an additional, non-refundable amount for the provision of an underground electricity supply, a developer is entitled to claim a deduction for that amount in the year of income in which it is incurred. However, such a payment is regarded as part of the cost of converting the land into the condition in which it will be sold and must be absorbed into the cost of trading stock.

Allocation of development costs to allotments

18. When land is subdivided, it is necessary to allocate the total acquisition and development costs to each of the individual lots. As a general rule, development costs should be allocated specifically, where it is practical to do so.

19. Where specific allocation is not practicable, we consider that the anticipated selling price method generally affords the most appropriate basis of allocating costs. However, any other reasonable method, consistently applied, that will match costs with related revenue may be used.

Multi-stage developments

20. Development costs attributable to the whole project may be incurred during an early phase of a multi-stage development project. In such a situation, these costs must be allocated to all items of trading stock, including the land that is to be used in later stages. This allocation should be made on a reasonable basis; for example, based upon engineering estimates.

Costs of constructing a fixed asset that enhances the value of trading stock

21. Where a fixed asset such as a golf course is constructed by a taxpayer as part of a subdivision development project, we accept that it may increase the value of the surrounding lots. However, where the taxpayer intends to retain ownership of the asset, rather than disposing of it in the normal course of its trading activities, no part of the cost of

that asset can be taken into account in calculating the cost price of the trading stock held by the taxpayer. The golf course is a fixed asset of the taxpayer's business and its cost is an outgoing of capital or of a capital nature. It is not a cost of acquiring trading stock.

22. However, if one of the conditions of obtaining approval to subdivide is to construct a public golf course that ultimately will vest in the Crown or other body, the cost of constructing it is part of the cost of acquiring trading stock. Such costs are treated in the same way as costs incurred in respect of other areas of land dedicated to special uses.

23. Where expenditure that relates both to the construction of a fixed asset to be retained by the developer and to trading stock is incurred, the costs may be allocated on a reasonable basis.

Date of effect

24. This Ruling applies to years commencing both before and after its date of issue. However, the 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).

25. If a taxpayer has a more favourable private ruling, this Ruling applies to that taxpayer, to the extent of the inconsistency, only with respect to development projects commenced after the issue of this Ruling (in its final form). This is subject to the exception that a public Ruling cannot withdraw an inconsistent legally binding private ruling if the year of income to which the private ruling applies has already commenced (see Taxation Determination TD 93/34).

Explanations

26. The decision of the High Court in *FC of T v. St Hubert's Island Pty Ltd (in liq)* (1978) 138 CLR 210; 78 ATC 4104; (1978) 8 ATR 452 clearly established the principle that land can come within the definition of 'trading stock' in subsection 6(1) of the Act. In that case, the High Court determined that land acquired for the purpose of development, subdivision and sale by a taxpayer carrying on a business of property development is trading stock. In deciding that land may be trading stock, the court did not distinguish between land acquired in a subdivided state and land acquired as broadacres.

27. Where land acquired by a taxpayer is trading stock, subsection 51(1) of the Act allows a deduction for expenditure incurred in

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acquiring and developing the land. However, this expenditure forms part of the cost price of the land for the purposes of subsection 31(1) and, as a result of the operation of section 28, the benefit of the deduction effectively is deferred until the land is sold or otherwise disposed of. The gross proceeds of sale of the land are brought to account as assessable income under subsection 25(1) in the year in which the land is sold (see *Gasparin v. FC of T* 94 ATC 4280; (1994) 28 ATR 130).

28. The effect of the relevant provisions is that the timing of the deduction is matched with the derivation of assessable income derived upon disposal of the land.

29. If land forms part of the trading stock of a taxpayer, the profit on sale cannot be returned on the 'net profit' basis. As the High Court decided in *Henderson v. FC of T* (1970) 119 CLR 612; 70 ATC 4016; (1970) 1 ATR 596, there cannot be alternative figures for calculating the assessable income of a taxpayer.

30. The definition of trading stock under subsection 6(1) has been held to include land on which it is intended that further work is to be done before it will be converted into the condition in which it is intended to be sold (see *St Hubert's Island* at CLR 228; ATC 4113; ATR 463 per Mason J).

31. The trading stock provisions will apply irrespective of whether the taxpayer has carried on the business of trading in land previously. For example, in *St Hubert's Island*, the taxpayer company was incorporated for the purpose of acquiring two small islands, and its intention was to develop the islands into a condition suitable for residential subdivision, to subdivide the land into residential allotments and to sell those lots. It was held that land acquired by a land developer for the purpose of development, subdivision and sale of allotments will constitute trading stock of the developer.

32. It follows that broadacres of land that are acquired by a taxpayer for the purpose of development, subdivision and sale will be regarded as trading stock of the taxpayer and must be accounted for in accordance with the trading stock provisions.

33. After the plan of subdivision has been registered and a separate title has been created for each of the subdivided allotments, the items of trading stock originally acquired by the taxpayer have been converted into subdivided lots, which then become the trading stock of the taxpayer, and must be accounted for accordingly.

34. Some tax commentators have taken the view that, in the context of land that is the subject of a plan of subdivision, it is only when the particular land is marketable that it constitutes trading stock. The decision of the Supreme Court of New South Wales Court in

Barina Corporation Ltd v. FC of T 85 ATC 4847; (1985) 17 ATR 134 is said to support this view.

35. We do not accept this view. In *Barina*, the taxpayer company acquired approximately 77 hectares of land to be subdivided. A plan had been prepared for the proposed subdivision. At a directors' meeting held on 25 June 1982, it was resolved that the land was to be treated as subdivided at that date and that each proposed lot would be treated as a separate item of trading stock and valued at cost, market selling value, or nil value in the case of land to be dedicated to the council. It was not until December 1983, after the taxpayer had complied with the conditions imposed by council, that the plan of subdivision was approved. In that case, Rogers J said at ATC 4855; ATR 143:

'...[P]roper effect can be given both to the text and to the legislative purpose if one regards, in the context of land proposed to be sold by subdivision, an article as trading stock only where the block of land is, in fact, marketable. Absent marketability there can be no market selling value. If absence of marketability is due to the fact that the land has not yet been converted to a subdivisible state, then I do not think that its individual but unidentifiable and non-segregated components can be said to be each an "article" of trading stock **distinct from the land *in globo***' [emphasis added].

36. His Honour concluded that the resolution of the directors failed to have the effect of converting the land, being various parcels of land acquired by the taxpayer company, into individual and identifiable articles of trading stock. At that stage, it was only the land *in globo* that was the trading stock of the company.

37. It follows that until the land has been converted into subdivided allotments, the proposed allotments cannot be treated as separate items of trading stock. Nevertheless, the parcels of land originally acquired by the company must be treated as separate articles of trading stock: see *St Hubert's Island* per Mason J at CLR 228; ATC 4113-4114; ATR 463.

38. For the purposes of the trading stock provisions, in the year in which the plan of subdivision is registered and separate titles are created for each of the subdivided lots, the articles of trading stock on hand at the end of the year of income will differ from the articles of trading stock on hand at the beginning of that year. In our view, there is a strong analogy to the manufacturing process where raw materials are converted into finished products. This analogy is supported by comments of Mason J in *St Hubert's Island* at CLR 227-228; ATC 4112-4113; ATR 461-463:

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'The recognition by accountants and commercial men that raw materials used for the purpose of manufacture in a manufacturing business and partly manufactured goods form part of the trading stock of the business was an almost inevitable development. It enabled the value of raw materials and partly manufactured goods to be included in the value of trading stock at the beginning and end of an accounting period and by this means it led to the making of a more accurate calculation of the profit earned or the loss sustained in that period...'

'...If trading stock according to its ordinary meaning denotes land as well as goods and commodities, it must follow that land may form part of the trading stock of a business before it has been converted into the condition in which it is intended to be sold. Just as raw materials and partly manufactured goods form part of the trading stock of a manufacturer, so also virgin land which has been acquired by a land developer for the purpose of improvement, subdivision and sale in the form of allotments will form part of his trading stock.'

Calculating cost price of trading stock on hand

39. In valuing trading stock on hand, subsection 31(1) of the Act allows a taxpayer the option of valuing each article of trading stock at its cost price, its market selling value, or the price at which it can be replaced.

40. Where a taxpayer values each item of trading stock at its cost price, the costs of development that are directly related to converting the land into the condition in which it is to be sold must be absorbed into the cost price of the trading stock for the purposes of subsection 31(1) of the Act.

41. There is little judicial authority on the meaning of 'cost price' and the method of valuing trading stock. The most definitive statement about the correct method of calculating 'cost price' appears in the decision in *Philip Morris*.

42. In that case the taxpayer manufactured and sold cigarettes and other tobacco products. It valued its trading stock on hand at the end of the year of income at cost, using the direct costing method. Under this method, the cost of finished cigarettes on hand at year's end comprised only the prices paid by the taxpayer for the materials going to make up the cigarettes and the wages of those employees who moved, or performed operations on, those materials in the course of the manufacturing process. The Commissioner argued that the absorption method should be used. This method requires that certain fixed factory overheads, such as wages of other employees and costs

of depreciation of plant and machinery, should be taken into account in determining the cost price.

43. The decision of Jenkinson J of the Supreme Court of Victoria was that the absorption costing method was the appropriate method of determining the cost of manufactured stock on hand at year's end. His Honour said at ATC 4360; ATR 52:

'The concept expressed by the words "cost price" in s. 31(1)...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.'

44. This decision reinforces the earlier Board decision in *Case No 19* (1946) 12 CTBR 128 where the Chairman of the Board stated at 192 that 'cost' meant:

'[T]he total cost of the stock to the taxpayer up to the relevant time, i.e., the expenditure incurred by him in acquiring the stock...and the further charges (if any) which he has incurred up to the relevant time in getting the stock into its then existing condition and location.'

45. We consider that the absorption cost method is the correct means of ascertaining the cost of trading stock on hand at the end of a year in a manufacturing business (see Taxation Ruling IT 2350).

46. Although both cases referred to above involve manufacturing situations, they are decisions dealing with the valuation of trading stock, and, to this extent, the principle that the cost price of trading stock should include costs incurred in the process of converting an article to the condition in which it is to be sold is relevant in determining the cost price of subdivided lots that become trading stock. As Mason J said in *St Hubert's Island* at CLR 229; ATC 4113; ATR 463, when discussing, with respect to land, the subsection 6(1) definition of trading stock:

'[N]o distinction should be drawn between goods on which work is to be done before they are converted into the condition in which they are intended to be sold and land on which work is to be done before it is converted into the condition in which it is intended to be sold.'

47. In the manufacturing process, the cost of all raw material is fully absorbed into the cost of the finished products, notwithstanding that some of the raw material is discarded in the process of obtaining the finished products. Similarly, when broadacres are purchased and converted into subdivided lots, the full cost of the broadacres is

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absorbed into the cost of the subdivided lots, notwithstanding that some parts of the broadacres are discarded in the process of obtaining the subdivided lots.

48. The analogy drawn by Mason J between manufactured goods and land was recognised also by Rogers J in *Barina*.

49. There is nothing in the income tax law that provides how cost price is determined for the purposes of the trading stock provisions. In *Philip Morris*, the court resorted to accounting principles on a matter involving the determination of the 'cost' or 'cost price' of trading stock, thereby indicating that on matters concerning the valuation of trading stock, reference to accounting principles may be appropriate.

50. Various accounting bodies have issued papers in relation to the correct method of determining the cost of trading stock of a land developer. A research study paper issued by the New South Wales Division of the Australian Society of Accountants in 1967 entitled 'Accounting for Long-Term Land Development Projects' was prepared by a committee chaired by Mr J W Emerson.

51. Under the heading 'Valuation of Inventory', the committee stated:

'The main item of inventory in a development firm is real estate which is being held for development or is undergoing development to prepare it for sale. It is analogous to the materials and work in process of a manufacturing firm.

The valuation of such property must follow the same general principles as are employed in the valuation of the trading stocks of other industries.

Cost Value of Inventory

Costs associated with the development of real estate are normally allocated to development projects and capitalised in inventory till the point of sale.'

52. The committee also said that the types of costs usually encountered in a developmental project include: the purchase price of land; legal and incidental costs of purchase; cost of development, including demolition, excavation, road construction, drainage, water reticulation, sewerage reticulation, survey costs, engineering costs, architect's costs; rates and taxes; and interest on funds employed in the project. They suggested that all costs directly associated with a particular project normally should be charged against that project and treated as an asset until the development is sold.

53. Further support for this view can be found in a discussion paper issued by the Australian Accounting Research Foundation in 1982.

This paper was prepared by Mr Philip A Phin and is entitled 'Accounting for Real Estate Development'.

54. In his paper, Mr Phin has this to say about matching costs with revenue:

'The question of capitalising costs arises when costs are incurred on a project in a period prior to the period in which the revenue from the project is brought to account. If such costs are written off when incurred there will be a mis-matching of costs and revenue - in the period in which the costs are written off profit will be under-stated, and in the subsequent period in which the revenue is recognised profit will be over-stated. It is generally agreed, therefore, that costs should be written off in the same period as that in which the resultant revenue is brought to account.'

55. In relation to the question of what costs should be capitalised, Mr Phin said that basically any type of cost incurred on a project can be considered for capitalisation. He then went on to consider direct acquisition, development and construction costs, and said:

'Direct acquisition, development and construction costs include not only the labour and material costs of physically developing property, but also the professional fees, contributions to councils, etc. necessarily incurred in obtaining planning approval and carrying the development through...'

'...It is generally agreed that such costs should be capitalised.'

56. In a research study paper published by The Canadian Institute of Chartered Accountants entitled 'Accounting for Real Estate Development Operations', the authors expressed their view as follows:

'Land development costs are those costs that are directly attributable to the development of land and to its ownership during the period of development. It is well established that such costs should properly be capitalised as part of the cost of land. Failure to treat such costs in this manner, but to expense them instead, is considered an over conservative and basically unsound treatment which in an extreme case would probably violate generally accepted accounting principles.

Land development costs would typically include such items as municipal taxes, interest, legal fees, consultants' fees, costs of roads, storm sewers and water mains. This list is of course not intended to be comprehensive. Other costs of a more indirect nature may also quite properly be classified as land development costs.

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For example, in most municipalities in Canada it is necessary to obtain municipal and provincial approval of a development or subdivision plan before any development can commence.

Approval is often conditional upon the developer providing, either at a nominal amount or free of charge, parkland, sites for schools or recreation centres; there may be requirements for street lighting, sidewalks, road allowances, or the development might require a given ratio of industrial and commercial to residential development; or cash levies may be imposed. Costs incurred in fulfilling any or all such requirements are considered to be land development costs.'

57. The Canadian revenue authority deals with the question of subdivision and development costs in Interpretation Bulletin IT-153R3, dated 7 October 1991 as follows:

'13. The costs in respect of installations within the subdivision area...include, but are not necessarily restricted to, costs of roads, sewers, watermains, street lighting, sidewalks, landscaping and recreational facilities. These costs are considered to constitute a component of the cost of the inventory of land... **This treatment is in accordance with generally accepted accounting and commercial reporting practices designed to achieve a reasonable and proper matching of costs with revenue.**

Where a portion of the property in the subdivision area is transferred from the land developer to a municipality or other government body under the requirements of the subdivision authorisation, the cost of such land, including the applicable portion of the above-mentioned installation costs, should be reallocated on a reasonable basis to the remaining parcels of land ...'[emphasis added].

58. In our view, having regard to both the relevant judicial authority and accounting principles, it is necessary, to achieve a reasonable and proper matching of costs with revenue, that all development costs relating to a land development project, incurred in converting the land into the condition in which it is intended to be sold, should be taken into account in calculating the cost price of trading stock on hand at the end of the year of income for the purposes of subsection 31(1) of the Act. For this purpose, all of the costs discussed in the papers referred to, with the exception of some administration and holding costs, are regarded as development costs.

Administration expenses

59. Whether administration expenses form part of the cost price of trading stock depends upon their degree of association to the particular

land development project. One of the unusual characteristics of the property development industry is that, because of the substantial expenditure involved, senior management often spend considerable time negotiating subdivision plans, purchasing land and arranging finance. When this occurs, administration costs may be so clearly associated with a particular project that they can be regarded as a direct cost of that project: for example, site administration expenses.

60. On the other hand, general administration expenses that are not specifically related to a development project are deductible in the year in which they are incurred, but do not form part of the cost price of trading stock on hand at the end of a year of income.

Holding costs

61. The authors of the papers referred to above have expressed the view that all costs directly associated with a project normally should be charged against that project and treated as an asset; that is, capitalised in inventory until the development is sold. However, in the case of holding costs such as interest, rates and taxes, we do not consider that they are part of the cost of converting the land into the condition in which it is going to be sold. Accordingly, they are deductible in the year of income in which they are incurred, but do not form part of the cost price of trading stock on hand (see Taxation Ruling IT 2350 and Taxation Determination TD 92/132).

Land dedicated to special uses

62. Generally, approval of a land development project or subdivision plan is conditional upon certain areas of land being dedicated for public use as roads and reserves. Alternatively, a developer may be required to make a monetary contribution to the local government authority. The land dedicated ultimately will vest in either the Crown or some other body, such as a local council. In this situation, taxpayers have argued that, upon vesting of the land, they have disposed of some of their trading stock for no consideration. Consequently, in the year of income in which the land vests, a taxpayer brings to account as trading stock on hand only that portion of the land that remains.

63. It has been argued further that the development costs incurred in constructing roads and footpaths, constructing sewerage and drainage works, and landscaping reserves and parklands are directly attributable to the land that has vested in the Crown or other body. Accordingly, the costs of acquiring and developing the land that is to be dedicated to special uses is not reallocated to the subdivided lots that comprise trading stock on hand after registration of the plan of subdivision.

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64. The corollary of this argument is that the value of all trading stock on hand at the beginning of the year of income exceeds the value of all trading stock on hand at the end of that year and the taxpayer is entitled to a deduction under subsection 28(3) for the amount of the excess. Effectively, this enables a deduction to be claimed in an earlier year of income than would be the case if those costs were reallocated to the subdivided lots.

65. We do not accept this argument. In our view, the cost of acquiring the broadacres and all costs of development are incurred in converting the trading stock (comprising the unsubdivided land) into the condition in which it is to be sold; that is, as fully-serviced lots which, themselves, constitute new trading stock. The agreement by the taxpayer to dedicate certain areas of land as roads and reserves and to undertake improvements to those areas of land is essential in order to obtain approval to convert the broadacres into subdivided allotments. The areas so dedicated, although derived from an article of trading stock (viz the land *in globo*) are not themselves trading stock, not being trading stock in general parlance nor having been purchased, manufactured, acquired or purchased for the purposes of manufacture, sale or exchange: see subsection 6(1) of the Act and *St Hubert's Island*. The areas are disposed of as part of the process of producing the subdivided land and the cost of such areas is, therefore, properly attributable to the lots in the subdivision.

66. In some instances, a taxpayer may be required to make a monetary contribution to the local government authority rather than dedicating areas of land to public use. That is also a cost of converting the land into the condition in which it will be sold and is properly attributable to the subdivided lots when determining their cost price for the purposes of the trading stock provisions.

67. We consider that the principle outlined by Rogers J in *Barina* clearly establishes that the cost of acquiring and developing the broadacres must be absorbed into the 'cost price' of all items of trading stock.

68. In that case, his Honour commented on the taxpayer's approach to valuing trading stock which was in the form of broadacres. The taxpayer purported to value that proportion of the broadacres which was to be dedicated to special uses at nil, with the remainder of the land valued at either market selling value or cost. As a consequence, the value of trading stock in closing inventory was significantly less than the acquisition cost. While the main issue revolved around the question of whether, prior to the actual subdivision of the broadacres, the land could be treated as subdivided so that each of the proposed allotments could be treated as separate articles of trading stock for the purposes of subsection 31(1) of the

Act, Rogers J did not accept the taxpayer's valuation of the land dedicated to special uses. By way of illustration, his Honour gave an example of how the taxpayer's approach would affect a leather merchant who was required to cut a cow hide into several pieces prior to selling the leather to a manufacturer. His Honour stated at ATC 4853; ATR 139:

'The merchant, on the appellant's approach, may, prior to cutting up the hide, value it at 95% of cost so far as the sections he will be utilising are concerned and at nil market value for the bits and pieces. The fact that he knows at the time of purchase that he will have to throw away bits and pieces, and calculates the price he pays with the knowledge that only 95% of the hide will be saleable, is irrelevant if one follows the appellant's approach. That would be an odd result from the statutory endeavour to throw up a more accurate barometer of the financial results of a business.'

69. It follows that, where a taxpayer opts to value trading stock on hand at cost price, the proper tax accounting treatment is to reallocate all development costs, including costs attributable to the land dedicated to special uses, on a reasonable basis, to each subdivided lot that has become an article of trading stock of the taxpayer. The land dedicated to special uses and vested in the local council does not at any time become separate articles of trading stock of the developer.

70. The land developer acquires the broadacres as trading stock. When the subdivision plan is registered, the broadacres are converted into subdivided allotments and a separate title is created for each lot. The subdivided lots then become the trading stock on hand of the taxpayer. The land dedicated to special uses generally vests in the Crown or some other body at the same time that separate titles are created for the subdivided lots; for example, see section 94 *Environmental Planning and Assessment Act 1979* (NSW).

71. Consequently, all costs incurred in obtaining approval for the subdivision, including the cost of land dedicated to special uses, the cost of providing infrastructure such as roads and kerbing, drainage and sewerage works, landscaping of areas dedicated to open space for parks, etc, and any monetary contribution made to council, are incurred for the purpose of converting the land into the condition in which it can be sold by the taxpayer. In effect, this is the consideration from the land developer to obtain approval from the council to subdivide the land. In the absence of any agreement by the taxpayer to dedicate certain areas of land for purposes specified by the council (or to make a monetary contribution in lieu thereof) and to construct the necessary works, the taxpayer would not be given approval to subdivide the land. By way of illustration:

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In June 1993, a taxpayer acquires three blocks of vacant land totalling 10 acres for \$100,000 for the purpose of developing, subdividing and selling as residential allotments. It is proposed to develop 20 lots. The taxpayer receives a deduction under section 51 of the Act for the expenditure incurred in acquiring the land. The taxpayer opts to value the land, which is trading stock on hand at the end of the 1992-93 year of income, at its cost price of \$100,000. That cost is allocated to each of the three articles of trading stock on hand in accordance with the contract price.

The taxpayer seeks approval from the local council to subdivide the land. Approval to subdivide the land is given in January 1994 and the taxpayer is required, as a condition of the approval, to dedicate approximately two acres of the land for roadways, footpaths and a public park, and to carry out the necessary infrastructure work. The taxpayer incurs \$25,000 development costs during the remainder of that year of income. The taxpayer is entitled to a deduction under section 51 of the Act for that expenditure. As in the prior year, the taxpayer opts to value trading stock on hand at the end of the year at cost price.

Applying absorption cost principles, the cost price is the original cost of acquiring the land and the costs of development incurred so far in respect of that land, being a total of \$125,000. Once again, the costs are allocated to each of the three articles of trading stock on an acreage basis.

In the 1994-95 year of income, the taxpayer incurs further development costs of \$75,000. Development work is completed in May 1995. Of the total development costs of \$100,000, approximately \$75,000 is incurred in respect of infrastructure development work on areas of land that ultimately will vest in the local council.

The plan of subdivision is approved by the local council and the linen plan is sealed in June 1995. The plan is registered immediately with the Registrar of Titles, who creates separate titles for the 20 residential lots. Separate titles are also created for the land dedicated to special uses, all of which vests in the local council by operation of law.

At the beginning of the 1994-95 year of income, the taxpayer has three articles of trading stock on hand and their opening value for tax purposes is the same as their closing value at the end of the prior year of income. However, at the end of the 1994-95 year of income, the taxpayer has 20 articles of trading stock on hand, being the 20 residential lots.

The taxpayer again opts to value trading stock on hand at cost and decides to allocate costs in proportion to the number of allotments in the subdivision, there being little difference between the characteristics of each of the lots.

In applying the principles of absorption costing, the taxpayer must include all expenditure incurred in converting the residential lots into the condition in which they can be sold.

The taxpayer, in converting the broadacres into subdivided lots, has surrendered a portion of the land originally acquired as trading stock (the land that vests in the local council), and has incurred infrastructure development costs in constructing, for example, roads and footpaths on that area of land. Nevertheless, all costs of acquiring the land and developing it to its subdivided state must be reallocated to the articles of trading stock on hand at the end of the 1994-95 year of income. The cost of the area of land dedicated to public use and the cost of any improvements to that land are part of the cost of converting the vacant land into the condition in which it will be sold by the taxpayer.

In this example, for the purposes of subsection 31(1) of the Act, the cost price of each article of trading stock on hand at the end of the 1994-95 year of income is \$10,000 ($\$200,000 \div 20$).

In the 1995-96 year of income, the taxpayer sells 15 of the lots for \$20,000 each. The proceeds of sale (\$300,000) are brought to account as assessable income in that year.

At the beginning of the 1995-96 year of income, the value of trading stock on hand is \$200,000 ($\$10,000 \times 20$). The value of trading stock on hand at the end of the year is \$50,000 ($\$10,000 \times 5$). Subsection 28(3) of the Act allows a deduction for the excess of the value of trading stock on hand at the beginning of the year over the value of trading stock on hand at the end of that year. In this example, the taxpayer is entitled to a deduction of \$150,000.

The net result of the trading activities for the 1995-96 year of income is a taxable income of \$150,000.

72. In our view, the above example is an application of recognised accounting principles in relation to absorption costing and provides the proper matching of revenue and expenditure required under the trading stock provisions.

Electricity Deposits

73. A situation may arise where a developer is required to provide a deposit/bond in connection with the provision of various services to a

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development project: e.g., connection of electricity supply. The appropriate tax treatment for such a deposit/bond will depend on the particular circumstances.

74. In particular, we are aware of a situation currently existing in one State in which a deposit is required in relation to the connection of electricity supply to subdivision developments.

75. In the case considered, the deposit is based on the estimated cost of providing overhead electricity supply to the subdivision. Some or all of this deposit is refundable by the supplier, subject to the terms and conditions of the agreement between the developer and the supplier. The electricity supplier is required to pay to the developer interest, calculated annually, on the balance of the deposit held.

76. The agreement provides that the subdivider (the developer) must guarantee a specific amount of annual revenue from the subdivision. If that amount is not achieved in any year, the supplier is entitled to an amount equal to the shortfall between actual and guaranteed revenue for that year. That amount is deducted from the deposit held by the supplier.

77. Once the supplier is satisfied that annual revenue from the subdivision will exceed the guaranteed annual revenue, it may repay, at its discretion, the balance of the deposit to the developer. In any event, the balance of the deposit is refundable not later than 15 years after the electricity supply is connected.

78. Alternatively, a reduced amount may be refunded immediately after the subdivision electricity supply is completed, or prior to the specified annual revenue being achieved. The reduced amount is the subdivider's deposit less the present value of anticipated shortfalls in guaranteed revenue.

79. For taxation purposes, the amount lodged by the developer as a deposit is a payment of a capital nature. Similarly, the amount refunded to the developer is a receipt of a capital nature.

80. On the other hand, any moneys retained by the supplier as a result of shortfalls, or anticipated shortfalls, in its guaranteed annual revenue, is deductible to the developer in the year of income in which the supplier becomes entitled to retain any part of the deposit. We do not consider that the expenditure incurred in these circumstances is part of the cost of converting the land into the condition in which it will be sold. These costs, in fact, may arise after development work has been completed and the sale of allotments has commenced. Accordingly, the expenditure is not absorbed into the cost price of trading stock on hand.

81. Any interest payable to the developer will be assessable in the year of income in which that interest is actually paid or credited to the developer.

82. Where a developer requires the supplier to provide an underground electricity supply to the subdivision, the difference between the cost of providing underground and overhead electricity supply is payable by the developer. This amount is non-refundable.

83. In this situation, the non-refundable amount paid to the supplier is deductible in the year of income in which it is incurred by the developer. However, we consider that this expenditure is a cost of converting the land into the condition in which it will be sold. Accordingly, this amount must be allocated, on a proportionate basis, to each item of trading stock. By way of illustration:

A developer requires underground electricity supply to a residential subdivision. The developer deposits an amount of \$100,000 with the local electricity authority. The authority is required to pay interest at the official semi-governmental short-term public rate, calculated annually, on the amount of the deposit.

The authority requires an additional payment of \$25,000, being the difference between the cost of supplying underground and overhead electricity. That amount is non-refundable.

The agreement between the developer and the authority provides for a guaranteed annual revenue to the authority from the subdivision of \$25,000. In the event of a shortfall in the guaranteed annual revenue, the authority is entitled to reduce the amount held on deposit by the amount of the shortfall in that year.

In the first year of supply, the revenue from the subdivision totals \$15,000, resulting in a shortfall of guaranteed revenue of \$10,000. The electricity authority reduces the amount on deposit by \$10,000. The balance of the deposit held is \$90,000.

In the second year of supply, the revenue from the subdivision totals \$20,000, resulting in a shortfall of guaranteed revenue of \$5,000. The electricity authority reduces the balance on deposit by \$5,000. The balance of the deposit held is \$85,000.

In the third year of supply, the revenue from the subdivision exceeds the guaranteed annual revenue. The authority agrees to refund the balance of the deposit held, plus accrued interest, and the agreement is cancelled.

For taxation purposes, the non-refundable payment of \$25,000 is deductible to the developer in the year in which it is incurred,

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but must be allocated, on a proportionate basis, to each item of trading stock on hand.

In relation to the shortfalls in the guaranteed annual revenue of the supplier, the developer is entitled to a deduction for the amount of the annual shortfall in the year in which the supplier is entitled to reduce the amount held on deposit, but is not required to absorb that amount into the cost price of trading stock on hand.

The amount of the deposit refunded to the developer is a receipt of a capital nature. However, interest payable on the deposit is assessable income of the developer in the year in which it is paid or credited or otherwise dealt with on behalf of the developer.

Allocation of development costs to allotments

84. The main reason for allocating development costs is to determine the cost price of each item of trading stock. This enables the appropriate cost of sales to be applied against income from sales. This is particularly important where, as is usually the case, not all the subdivided allotments are sold in the same year of income. Any errors in allocating costs will directly affect the valuation of the remaining lots on hand at the end of the year of income and, hence, the developer's tax liability for that particular year.

85. Since many items of expenditure are attributable to each of the subdivided allotments, the most appropriate method of allocation will depend on the circumstances of each case. As a general rule, development costs should be allocated specifically, where it is practical to do so. Where specific allocation is not practicable, we consider that the anticipated selling price method generally affords the most appropriate basis of allocating costs. However, any other reasonable method, consistently applied, that will match costs with related revenue may be used. Listed below are recognised accounting methods of allocating costs in a land development project (or a particular stage of a multi-stage project).

Specific Identification

86. Costs which can be specifically identified with a particular subdivision project or individual lot are allocated directly thereto. In our view, development costs should be allocated specifically in all cases where it is practical to do so.

Anticipated selling price

87. Under this method, costs are allocated on the basis of the anticipated selling price of each allotment. For example, this method sometimes is used where the project consists of a combination of residential, industrial and commercial sites.

Lots or sites

88. Costs are allocated in proportion to the number of proposed lots or sites. This is a simple method of allocating costs, but no recognition is given to the different characteristics of the lots, such as their size or location.

Area

89. Costs are allocated on the basis of the total saleable area in the development. This method recognises the differing sizes of lots but not the fact that some will have different sales values to others. This method is often used to allocate the costs of staged projects being developed over a lengthy period. For example, it is common practice to allocate the cost of land to each stage of a subdivision on an acreage basis and then allocate the land costs of each stage on the metre frontage basis or anticipated selling price basis, as outlined below.

Metre frontage

90. Costs are allocated to the lots in the proportion of the metre frontage of each block to the total metre frontage of the trading stock. This method is commonly used in residential developments in which only one type of dwelling unit is to be constructed. It does not take into account the size of irregularly shaped lots, or the location of the lots in the subdivision, but does recognise that lots with greater metre frontage may be more valuable.

Multi-stage developments

91. A development project may be planned to proceed in clearly defined stages over a number of years. Often a separate entity is established specifically to carry out the staged development.

92. Development costs attributable to the whole project may be incurred during an early phase of a multi-stage development project. In such a situation, these costs must be allocated to all items of trading stock. This allocation should be made on a reasonable basis; for example, based upon engineering estimates. By way of illustration:

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An island development to be undertaken in three stages requires a bridge to be constructed to provide access to the land under development. The costs of constructing the bridge are attributable to the whole of the project and must be allocated to each stage of the development accordingly.

93. Further examples of the types of expenditure that are attributable to the whole development are:

- Contributions to local government authorities for the upgrading of an access road to the project;
- Construction of oversized sewers and water mains for the whole project;
- Construction of a reservoir to service the whole project;
- Downstream drainage in order to take stormwater runoff from the whole project to a lawful point of discharge.

94. It is a common problem for staged development projects to suffer from uncertainty. Conditions imposed by the regulatory authorities may be subject to change. For example, there could be a change of council and the new council may require additional land for parkland. Alternatively, new by-laws may be passed which prohibit the developer constructing houses above a certain height on the side of a hill.

95. It has been argued that the trading stock method of returning income disadvantages taxpayers where the early stages of the project are successful but the later stages become unsuccessful because of changes in council requirements. Where 'losses' are made in later years, they may be locked into single purpose entities. Because of the uncertainty associated with staged developments, it has been proposed that income should be returned on a net profit basis: that is, net proceeds from the sale of allotments are brought to account as sales occur.

96. We do not accept this proposition. A basic principle of the income tax law is that liability to income tax is an annual event and if, in a staged development, the sale of allotments in an initial stage of the development generates assessable income, then that assessable income must be brought to account in the year in which the sales occur. A taxpayer generating assessable income from a trading business cannot defer returning assessable income until all the items of trading stock are sold.

97. Furthermore, although an entity may be created specifically to undertake a particular land development project, the trading stock provisions will apply (see *St Hubert's Island*).

Costs of constructing a fixed asset that enhances the value of trading stock

98. Typical of an integrated resort development is the construction of fixed assets such as a golf course, tennis courts, swimming pools, etc. We accept that the construction of these facilities will increase the value of the residential land.

99. Taxpayers have argued that where, for example, a golf course is constructed, it has only a limited value, based upon the typical poor economic return from the operation of a golf course. Accordingly, it is argued, on economic grounds, that the majority of the capital expenditure on the golf course is attributable to the surrounding parcels of real estate, including residential sites, the value of which will be significantly increased by the construction of the golf course.

100. However, the cost of such fixed assets is clearly capital in nature and cannot be taken into account in determining the cost price of trading stock on hand.

101. Nevertheless, where expenditure is incurred that relates both to the construction of a fixed asset to be retained by the developer and to trading stock, the costs may be allocated on a reasonable basis. By way of illustration:

During the course of developing an integrated resort, soil excavated during construction of a golf course is used to fill and level surrounding areas of land that will be subdivided. The costs of excavation and removal relate to both the construction of the golf course and development of proposed allotments. These costs may be allocated accordingly.

102. Alternatively, a taxpayer may be required, as one of the conditions of obtaining approval to subdivide, to construct a public golf course that ultimately will vest in the Crown or other body upon registration of the plan of subdivision. In this situation, the cost of constructing the golf course is regarded as part of the cost of converting the undeveloped land into the condition in which it will be sold. Consequently, these costs are treated in the same way as costs incurred in respect of other areas of land dedicated to public uses.

Examples

103. Company A is in the business of land development. It acquires vacant land to develop and subdivide into 50 residential allotments for sale.

104. A plan for the subdivision is submitted to the local council and approved on condition that the company pays \$500,000 to the council

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for upgrading off-site sewerage works and agrees to dedicate land within the subdivision as roads and reserves.

105. During the year, the company incurred the following costs:

- Land acquisition
- Interest on funds borrowed to acquire the land
- Professional fees for design work, including drafting, architectural, engineering and surveying
- Council application fees for the subdivision
- Contribution to council for upgrading of off-site sewerage works
- Construction of roads
- Salary and wages to working directors
- Motor vehicle expenses
- Rates and land tax
- Travelling expenses
- Telephone expenses
- Office expenses
- Accounting fees
- Printing and stationery expenses
- Marketing, advertising and selling expenses.

106. Assuming that the taxpayer has opted to value trading stock on hand at its cost price, what is the tax treatment of the above expenditure?

107. In this particular example, all of the above expenditure qualifies as allowable income tax deductions when incurred by a land developer. Most are allowable under subsection 51(1) of the Act, while some may be allowable under specific provisions, such as rates and taxes under section 72, and accounting fees under section 69 of the Act.

108. The following holding costs do not form part of the cost price of the trading stock and are deductible under subsection 51(1) of the Act in the year they are incurred:

- Interest on funds borrowed to acquire the land
- Rates and land tax
- Marketing, advertising and selling expenses.

109. The following development costs are absorbed into the cost price of trading stock:

- Land acquisition
- Professional fees for design work, including drafting, architectural, engineering and surveying
- Council application fees for the subdivision
- Contribution to the council for off-site upgrading of sewerage works
- Construction of roads.

110. The following costs form part of the cost price of the trading stock where they are clearly identified with the development of the specific project. Otherwise these costs are deductible under subsection 51(1) in the year they are incurred, but are not reflected in the cost price of trading stock:

- Salary and wages to working directors
- Motor vehicle expenses
- Travelling expenses
- Telephone expenses
- Office expenses
- Accounting fees
- Printing and stationery expenses.

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Your comments

112. If you wish to comment on this Draft Ruling, please send your comments by: 13 September 1995

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legislative references

- ITAA 6(1)
- ITAA 25(1)
- ITAA 28
- ITAA 28(3)
- ITAA 31(1)
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- ITAA 69
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