

TR 93/3 - Income tax: trading stock of gold miners

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Taxation Ruling

Income tax: trading stock of gold miners

other Rulings on this topic

IT 2085 TR 92/5

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*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

1. Section 28 of the *Income Tax Assessment Act 1936* requires a taxpayer carrying on a business to take into account the value of all trading stock on hand at both the beginning and the end of the income year in determining its taxable income for that year. In so doing, section 31 allows the taxpayer to value the trading stock at its cost price, its market selling value or at the price at which it can be replaced.
2. The income of gold mining businesses, formerly exempt, became taxable on 1 January 1991. Division 16H of Part III was inserted to legislate for that change. Section 159GZZZBG of Division 16H provides that a taxpayer which carries on a business of gold mining is to take into account the value of all trading stock on hand at 31 December 1990 under section 28. Section 159GZZZBH allows the taxpayer to adopt the section 31 options for valuing the stock.
3. This Ruling explains:
 - (a) the stage in the mining process when ore becomes the trading stock on hand of a taxpayer which is in the business of gold mining; and
 - (b) how a market selling value of trading stock can be adopted to value that stock for the purposes of section 31.

Ruling

- (a) **The stage in the mining process when ore becomes the trading stock on hand of a taxpayer which is in the business of gold mining**

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4. The trading stock of a taxpayer which is in the business of gold mining includes not only the refined gold ultimately produced by the taxpayer but also any partly refined products, concentrates, and any stockpiles and dumps of mined ore on hand or in transit.

5. The ore is to be treated as trading stock on hand as soon as it is severed from the land, that is, when it is broken from the ground.

(b) How a market selling value of trading stock can be adopted to value that stock for the purposes of section 31

6. Market selling value is the current value of the article of trading stock in the taxpayer's selling market. That will ordinarily be based on the Australian spot sales market price of gold, for an Australian gold miner.

7. It is not possible to adopt a forward sales market price of gold.

8. A market selling value can only be adopted for trading stock for which there is an identifiable market value. Market valuation may be used for gold trading stock which is actually bought and sold in the industry. Partially processed gold ores and gold tailings may fall into this category.

9. Where necessary, a notional market selling value may be calculated for trading stock which is gold work-in-progress based on the spot market price, reduced by estimated processing costs to produce the gold and by an estimated profit margin. The notional market value must be reasonable when compared with actual sales in the gold industry and actual profit margins.

Date of effect

10. This Ruling has both a past and future application (see Taxation Ruling TR 92/20). However, it does not have a past application for a taxpayer who has agreed to a settlement of a dispute to the extent that the Ruling is less favourable than the settlement terms. To the extent that the Ruling is more favourable, it does not have a past application for the taxation years the subject of the settlement.

Explanations

(a) The stage in the mining process when ore becomes the trading stock on hand of a taxpayer which is in the business of gold mining

11. The term **trading stock** is defined in subsection 6(1) to include 'anything produced, manufactured, acquired or purchased for purposes of manufacture, sale or exchange, and also includes livestock'.

12. The High Court of Australia (per Jacobs J) explained that the purpose of this definition is 'to ensure that not only that which is in a condition ready for sale but also that property (at any rate moveable property) which is intended to be worked on or even used up in a process of manufacture will fall within the meaning of the words "trading stock" in the Act, as well as the things produced or manufactured and things acquired or purchased for sale or exchange' (see *FC of T v. St Hubert's Island Pty Ltd* (1977) 138 CLR 210 at 235). It is clear from the cases that the work-in-progress of a business is to be regarded as trading stock.

13. The High Court in the *St Hubert's Island case* related work-in-progress to a process of manufacture. The suggestion has been made that work-in-progress is limited to what would commonly be understood to be manufacturing and should, therefore, not apply to a mining business. Such an approach is not justifiable. In the *St Hubert's Island case* itself, the High Court regarded a partly developed subdivision as work-in-progress (see for example Mason J, at 229 and Jacobs J, at 235). The inference is that either the word 'manufacture' is read in a broad sense, or the notion of work-in-progress is in no way limited to manufacturing.

14. Support for a broad view of the meaning of 'manufacture' can be drawn from *Case Q106* 83 ATC 547, where Dr Gerber found that the construction of houses under a contract for work and materials was manufacture. He said that 'the process of manufacture involves the production of articles for use from raw materials which gives these materials a new form, quality and/or property which they did not possess before' (at 550).

15. Our view is that broken ore is work-in-progress of a mining business. That ore is the raw material to be refined into a marketable commodity. For the purposes of the subsection 6(1) definition of trading stock, the refinement of the mined ore is regarded as being a manufacturing process. Accordingly, the trading stock of a gold mining business includes not only the refined gold sold by the taxpayer but also stockpiles of mined ore, refined or partly refined gold and dumps of raw materials.

16. Further, the ore to be included in trading stock is to be included as soon as it is severed from the land. There is no reason to delay treating the ore as trading stock until it is stockpiled. Broken ore which is ready to be stockpiled and mined ore which has already been stockpiled, either at the rock face or elsewhere, will be treated as trading stock. This is consistent with Approved Accounting Standard

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ASRB 1022: Accounting for the Extractive Industries para .50, binding on resource companies, which states that "inventories shall be brought to account at the earliest stage at which materials representing, or expected to be converted by further processing to, saleable product can be measured with reliability and the quantities of such materials can be determined by physical measurement or reliable estimate". Commentary (*xvi*) to this standard gives the example of broken ore collected at the point where ore-breaking first occurs. Ore which remains attached to the land is not trading stock, even though it may already have been exposed and its value quantified.

17. Ore that has been severed from the land will usually become part of the land again when it is abandoned by a miner: *Mills v. Stokman* (1967) 116 CLR 61. Gold miners working the tailings of abandoned mines may usually only include the tailings which have been extracted from the tailings dump as trading stock once they are again severed from the land.

18. Whether a tailings dump has been abandoned is a question of fact and degree. The case of *Mills v Stokman* dealt with a slate dump which was left untouched for 24 years and where there was no intention to rework the dump at the time it was left on the land. The full High Court held the dump had been abandoned and had become reattached to the land. In *Golden Horse Shoe (New) Ltd v Thurgood* (1933) 18 TC 280, gold tailings were left for only one year before being claimed as trading stock. The original owner sold its gold mining leases, plant, etc to another but retained for 10 years all rights to its old tailings. The English court found the tailings were not abandoned. We consider that the legal reasoning of this case cannot be preferred to the analysis in *Mills v Stokman*. However, it demonstrates some of the factors to be taken into account in determining abandonment.

(b) How a market selling value of trading stock can be adopted to value that stock for the purposes of section 31

19. Many cases over the years have indicated that, for the purposes of section 31, the **market selling value** of an article of trading stock is the current value of the article in the taxpayer's selling market. It does not represent the price the article may command on a forced realisation, nor the price at which it may be expected to sell at some time in the future. Rather, it represents the price which the taxpayer would expect to receive for that article if it were sold then in an ordinary way. When valuing trading stock on hand on the last day of an income year for the purposes of section 31, the best evidence of that price is the spot market price on the last day of the income year. That

price is not, of course, reduced by the likely impact of all similar stock on hand being dumped on the market on that day.

20. This definition has led some to argue that where a taxpayer in the business of gold mining habitually sells a proportion of its gold production or even virtually all that production, under forward sales, that taxpayer ought to be entitled to value a similar proportion of its stock on hand using a forward sales market value. After all, the argument goes, one of the taxpayer's selling markets is the forward sales market.

21. This is a mistaken view of what a taxpayer's selling market is. A taxpayer's market may be wholesale or retail; so the gold stock of a miner, a manufacturing jeweller, or a retailer might have disparate values for the same item on the same day. But a forward sale is simply an agreement to deliver goods in the future, not a present sale of those goods. It does not relate to the trading stock which the taxpayer has on hand. Nor does it relate to the taxpayer's market. A forward sale of gold does not dispose of any trading stock the gold producer may have on hand when it enters into the agreement. The contract need not be fulfilled with stock of the gold producer but may be closed-out in other ways. In addition, stock on hand only diminishes as property actually passes to the purchaser in satisfaction of the forward sale agreement.

22. Accordingly, a forward sale price cannot represent the market value of stock on hand. This is consistent with Australian Accounting Standard 7, para 40 and Approved Accounting Standard ASRB 1022 on the Extractive Industries, para .60. The latter states that sales revenue shall not be brought to account until the product is in the form in which it is to be sold and either property in the product has passed to the vendor, or the product has moved finally from the physical control of the vendor pursuant to an enforceable sales contract and it can be established that the product is for the purchaser's account under that contract. As explained above, this is not satisfied by entering into a forward sales contract.

23. In *Australasian Jam Co v FCT* (1953) 10 ATD 217, Fullagar J of the High Court was concerned only to emphasise that a "forced" or "bargain" sale price is not an accurate valuation of trading stock and that the price gained "in the normal course of business" should be used (at 221). For gold sales, the fair and reasonable price for a "willing but not anxious" buyer and seller at the end of the financial year is the spot market price on that day.

24. A particular market's expectation of future price cannot be used as the market selling value. Nor can a spot price, adjusted by a consideration designed to compensate the seller for delay in payment or cost of holding stock. These are alternative perspectives on forward

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sale prices. This is consistent with the English case *Brigg Neumann & Co v IRC* (1928) 12 TC 1191, where it was held that a forward sales price could not be used as a notional market selling value because it involved "adjusting [the] price with reference to something which is going to happen in the future which is not yet known" (per Rowlatt J at 1203). Rowlatt J approved a method of arriving at the value of cloth on hand which is inapplicable to the different Australian provisions (although similar to replacement valuing). His refusal to consider the forward sale prices in valuing stock of a cloth dealer who sold all stock forward is authoritative.

25. The gold forward sales price is partly dependent on a forecast of the future gold price. Once set, it does not fluctuate with the spot price and may be calculated for any time in the duration of the contract. If this were not so, the forward contract itself may be void for uncertainty. However, the factors of gold fee, interest rate and credit margin which are said to make up the contango are determined independently by each party to the contract. Although the forward price can be broken down into contango and spot market price at time of contract, it is not calculated from these factors.

26. This is demonstrated by spot deferred forward contracts (floating forwards) where a price is set for a commencement date and an expiry date and the contract may be closed-out at any time between these dates. A contango is implicit in the difference between the two prices, and in fact must be calculated if the contract is closed-out during the contract period. It is derived from the fixed prices, not used to set them. Floating forwards are used to influence or supersede the spot price; a contract will not be closed-out before its end date if there is no advantage (in relation to the spot market price of gold) in doing so.

27. The dependence of the forward price on each party's estimates of the future gold price is further demonstrated by the fact that in the setting of a forward contract price, a lower price will be set in the face of current market predictions that the gold market will drop.

28. Accordingly, the forward sales price of gold cannot be adopted to value trading stock on hand. For gold which is on hand at the end of an income year, the relevant market selling value is ordinarily the current Australian spot market price.

29. The need to identify a selling market also means that the particular item of trading stock must actually be in a marketable form if a market selling value is to be adopted. In general, this would exclude the market valuation option from application to many forms of work-in-progress. The decision in *Parfew Nominees v FCT* 86 ATC 4647 demonstrates that a section 31 valuation option may be unavailable to a taxpayer if it is inappropriate in the circumstances. The decision applies to gold valuation under section 159GZZZBH.

Thus, for example, if untreated ore is not a tradable commodity, it will be necessary to value that ore either at its cost price or its replacement value.

30. For example, market valuation would not be appropriate in the valuation of broken ore, which does qualify as trading stock, if the amount of gold in the ore is not yet ascertained or capable of reasonable estimation.

31. The gold mining industry is a special case. Because of the high value of the final product, partly treated and untreated gold ore, and occasionally gold tailings, are quite often actually traded in the industry. Therefore, it is considered that the market selling value may be appropriate for the gold industry.

32. In some cases, it may be possible to determine an actual market value for gold work-in-progress where there are sufficient sales in the industry. In general, because of the infrequency of such sales, this will not be possible. Therefore, a notional market selling value can be adopted for partly processed gold stock where there is enough evidence for this to be calculated: *Brigg Neumann* 12 TC 1191, *Case 120* [1948] CTBR (NS) vol. 1, *Case 5* [1953] CTBR (NS) vol. 4.

33. In general, a market sales value for an actual sale of partly processed gold stock (assuming that the vendor has surplus stockpiled ore, the purchaser has run short and they have similar production costs) may be estimated as follows:

	Market spot price
Less:	Further estimated production costs
	Estimated profit margin
Result:	Offer price from Purchaser to Vendor

34. This method has been suggested by industry and professional submissions, although it is not based directly on sales of the work in progress. The assumptions made accord with commercial reality and are reasonable. Whenever there is an actual sale, the price will obviously depend on the specific circumstances of both the vendor and purchaser. Actual prices of partly processed gold ore and tailings will be used as a guide for notional market valuation of trading stock. Notional market values in which the above factors are taken into account for the hypothetical willing but not anxious purchaser and vendor, and which appear reasonable when compared with actual prices of partly processed stock in the gold industry and actual profit margins, will be accepted for the purpose of trading stock valuation under section 31.

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- ITAA 28; ITAA 31; ITAA 159GZZZBG; ITAA 159GZZZBH

case references

- Australasian Jam Co v FCofT 1953 10 ATD 217
- Brigg Neumann & Co v IRC 1928 12 TC 1191
- Golden Horse Shoe (New) Ltd v Thurgood 1933 18 TC 280
- Mills v Stokman 1967 116 CLR 61
- Parfew Nominees v FCofT 1986 86 ATC 4647
- FC of T v St Hubert's Island Pty Ltd 1977 138 CLR 210
- Case 120 [1948] CTBR (NS) Vol 1
- Case 5 [1953] CTBR (NS) Vol 4
- Case Q106 1983 83 ATC 547