TR 93/9 - Income tax: deferral of deductions for trading stock purchases involving prepayments

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Generated on: 26 November 2026, 05:10:35 AM

Australian Taxation Office

Taxation Ruling
Income tax: deferral of deductions for trading stock purchases involving prepayments

*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.*

*[**Note:** This is a consolidated version of this document. Refer to the Tax Office Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]*

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What this Ruling is about

1. This Ruling contains general guidance on the operation of section 70-15 of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] and explains how the provision applies to certain expenditure by primary producers and to expenditure incurred under certain livestock breeding arrangements. Section 70-15 defers deductions in respect of certain expenditure incurred in a year of income in acquiring stock which will become trading stock of a taxpayer but has not become trading stock on hand at the end of the year of income.

Ruling

2. Subsection 70-15(1) describes the type of expenditure which is subject to the operation of section 70-15 as 'an outgoing incurred in connection with acquiring an item of trading stock'. In our view, these words, read in the context of section 70-15 and the rest of the ITAA 1997, have the effect that section 70-15 cannot apply to expenditure incurred in bringing trading stock into existence through manufacturing or production processes of the taxpayer, except to the extent that the expenditure relates to the acquisition of inputs to the manufacturing or production process which are themselves trading stock (and then only where the rest of section 70-15 is satisfied in relation to the last-mentioned trading stock). A corollary of this is that the section can only apply to expenditure that is incurred in the

[1] All subsequent legislative references are to the ITAA 1997 unless indicated otherwise.

acquisition of stock which is expected to come on hand as trading stock of the taxpayer.

3. We have considered whether section 70-15 can apply to expenditure of a primary producer on seed for planting or on semen for the artificial insemination of livestock, or the part of the purchase price of an orchard that is attributable to a growing crop. Our view is that section 70-15 does not apply to these types of expenditure.

4. We have also considered whether the section applies to expenditure by taxpayers under what might be termed livestock breeding arrangements. The view of this Office is that, if a taxpayer's participation in such an arrangement constitutes or forms part of a business of the taxpayer of breeding livestock (whether carried on alone or in partnership), the subsection will not apply. Section 70-15 can apply, however, where the taxpayer's participation does not constitute or form part of a business of breeding livestock but relates to the conduct of other business activities, for example, the buying and selling of cattle. In such a case the subsection will apply to so much of the expenditure incurred under the arrangements as is incurred in acquiring the livestock as trading stock of the taxpayer.

Date of effect

5. This Ruling explains the operation of section 70-15 of the ITAA 1997 and the provision it replaced, subsection 51(2A) of the *Income Tax Assessment Act 1936* (ITAA 1936). Subsection 51(2A) of the ITAA 1936 applied to expenditure incurred from 19 December 1991 to the 1998 year of income. Section 70-15 of the ITAA 1997 applies to expenditure incurred in the 1998 and later years of income. Therefore it 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).

Explanations

6. The views expressed in paragraphs two, three and four of this Ruling are based on what we consider to be the ordinary meaning of section 70-15 conveyed by its text. Other related parts of the legislation, the potential capricious operation of other interpretations and the intention of Parliament evinced from extrinsic material confirm that meaning.

7. The words ‘acquired’, ‘manufactured’ and ‘produced’ are all used separately in the definition of trading stock in section 70-10. In the related context of section 70-15, it would seem to follow that the ordinary meaning of ‘acquired’ cannot be taken to include ‘produced’ or ‘manufactured’. The word ’becomes’ in paragraph 70-15(3)(a) merely ensures that the provision can apply to forward purchase contracts where payment precedes the coming on hand of the stock purchased and under which the particular stock itself is trading stock of a taxpayer when it comes on hand. The word does not describe a process by which stock ‘becomes’ trading stock by changing its nature in some way. It does not, for example, describe the process by which seed acquired for planting grows into a crop ready for harvesting, a growing crop turns into a harvested crop, an embryo grows into a live animal, or raw materials are made into a manufactured article.

8. If ‘acquired’ included manufacture and production then section 70-15 could apply to defer deductions for the cost of inputs to those processes that are themselves ‘stock’ that has not attracted section 70-15 in its own right. If ‘becomes’ included the processes by which the metamorphoses referred to above occurred, section 70-15 could apply to expenditure on, say, crop seed or raw materials but not on fertiliser or fuel. Interpreting the section in this way would be inconsistent with the intention of the legislation.

9. Extrinsic material supports the meaning ascribed to subsection 70-15(1) of the ITAA 1997 in paragraph 2 of this Ruling. The Explanatory Memorandum to the Taxation Laws Amendment Bill (No.4) 1991, states that subsection 51(2A) of the ITAA 1936 (the replaced provision) was intended to deal with forward purchase contracts (exemplified in *F C of T v Raymor (NSW) Pty Ltd* 90 ATC 4461, (1990) 21 ATR 458) and other situations, such as goods in transit, where expenditure on the direct acquisition of trading stock is incurred before what is being purchased itself becomes trading stock on hand.

Livestock breeding arrangements

10. The phrase ‘livestock breeding arrangements’ in paragraph four of this Ruling is intended to describe generally arrangements under which a taxpayer or taxpayers incur expenditure for the production of livestock. Usually the livestock are bred under the arrangement using the services of a person with expertise in some specialist breeding technique. Often the arrangement involves the taxpayer or taxpayers leasing livestock for the term of the arrangement for use in the breeding process. The question arises whether the expenditure incurred under the arrangement is subject to section 70-15 in the sense

that it is expenditure incurred in connection with the acquisition by the taxpayer or taxpayers of the livestock produced under the scheme.

11. Cases that have dealt with livestock breeding arrangements such as *Ferguson v F C of T* 79 ATC 4261, 9 ATR 873, *Hanlon v F C of T* 81 ATC 4617, 12 ATR 540, *Walker v F C of T* 85 ATC 4179, 16 ATR 331, *F C of T v Solling; F C of T v Pepper* 85 ATC 4518, 16 ATR 753 and *Case R7* 84 ATC 151, *Case 58*27 CTBR(NS) 515 make it clear that it cannot be assumed that a participant in such an arrangement will be entitled to a deduction for the expenditure incurred under the arrangement, nor that participation will automatically make the livestock produced the trading stock of the taxpayer. As the cases show, the answers to those questions depend on the circumstances of the individual taxpayer. Section 70-15 will not be relevant, of course, if the expenditure is not deductible in the first place or, if deductible and incurred in acquiring the livestock, the livestock are not trading stock of the taxpayer.

12. The view expressed in paragraph four of this Ruling that section 70-15 does not apply to expenditure incurred under a livestock breeding arrangement which constitutes or forms part of a livestock breeding business of the taxpayer is arrived at because in such a circumstance, the product of the arrangement (that is, the livestock which the taxpayer receives) is considered to be brought into existence as a result of the taxpayer's own production activities, and so is not acquired by the taxpayer in the sense contemplated by section 70-15 (as explained in paragraph two of this Ruling).

Examples

Example One

A farmer incurs the following expenditure in establishing a crop of wheat:

- $1,000 in purchasing wheat seed for sowing;
- $1,000 in purchasing fertiliser; and
- $1,000 on irrigation costs.

Question: Do any of these items of expenditure fall within subsection 70-15(1)?

- Section 70-15 will not defer any deduction in respect of the $1,000 cost of the seed. Although seed might well be called stock, it does not constitute trading stock when it is held by a farmer for planting as it is not ‘produced manufactured or acquired…for purposes of manufacture, sale or exchange’ as required by paragraph 70-10(a).

Accordingly, in relation to the seed, the expenditure is not incurred by the farmer in acquiring stock which is trading stock.

- None of the three amounts, any of which might be thought of as expenditure incurred in 'acquiring' (in a very broad sense, but not in the sense in which the section uses the word) the harvested wheat, are within subsection 70-15(1) in relation to the wheat.

Example Two

A cattle farmer incurs the following expenses:

- $1,000 in having some cows serviced by a bull;
- $2,000 in obtaining embryos to implant in some other cows;
- $500 in veterinary services in carrying out this procedure; and
- $5,000 in purchasing some calves from another farmer.

Question: Are any of these items of expenditure within subsection 70-15(1)?

- The $1,000 service fee is not within subsection 70-15(1). Although the calves born to the serviced cows will be the trading stock of the farmer, they are produced, not acquired.
- The $2,000 cost of the embryos is not expenditure which is within subsection 70-15(1). Although the embryos are acquired by the farmer, they are not held by the farmer as trading stock. Further, even if they are treated as stock, they do not 'become' the eventual calves within the meaning of the provision.
- For the reason given in relation to the $1,000 service fee, the $500 veterinary fee does not fall within subsection 70-15(1).
- The $5,000 purchase price of the calves obtained from the other farmer is expenditure within subsection 70-15(1). These calves come on hand as trading stock, and are acquired, not produced, by the farmer.

Example Three

An orchardist incurs the following expenditure:

- $50,000 acquiring an apple orchard, $10,000 of which is attributable to a crop of apples growing on the trees at the time of purchase; and
- $2,000 in tending the trees and harvesting the apples.

Question: Are the $10,000 and $2,000 amounts of expenditure falling within subsection 70-15(1)?

- The $10,000 amount is not within subsection 70-15(1). The thing that is acquired with the expenditure, that is, the growing crop of

apples, is not stock and cannot, in its unharvested state, constitute trading stock (see, for example, 11 CTBR *Case 14*).

- Nor is the $2,000 within subsection 70-15(1). This amount might be thought of as expenditure incurred in acquiring the harvested crop. However, although the apples are the trading stock of the orchardist once harvested, they are not 'acquired' within the meaning of the paragraph. They are the product of a primary production process.

Example Four

A manufacturer incurs the following expenditure:

- $10,000 in the purchase of raw materials;
- $5,000 on fuel, labour and other factory costs in processing those raw materials into an intermediate product; and
- $3,000 in processing that intermediate product into a finished product.

Question: Are any of these amounts expenditure to which section 70-15 can apply; that is, do any of them fall within subsection 70-15(1)?

- A manufacturer's raw materials are considered to be trading stock in themselves. The $10,000 for raw materials is therefore expenditure which is within subsection 70-15(1) in relation to the raw materials, but not in relation to the intermediate or finished product.
- The $5,000 processing cost is not expenditure within subsection 70-15(1). While it is expenditure on work in progress, which will generally be trading stock in itself, work in progress is not acquired by a manufacturer in the sense in which that word is used in the paragraph.
- For the same reasons, the $3,000 processing cost will not fall within subsection 70-15(1).

Commissioner of Taxation
8 April 1993

Previously released in draft form as TR 93/D4

ISSN 1039 - 0731

Price $0.60

ATO references
NO L90/7095-8
BO

FOI index detail
reference number
I 1013632

subject references
- allowable deductions
- artificial insemination
- breeding
- livestock
- manufacturers
- prepaid expenses
- primary producers
- trading stock

legislative references
- ITAA 1936 51(2A)
- ITAA 1997
- ITAA 1997 70-10
- ITAA 1997 70-15
- ITAA 1997 70-15(1)
- ITAA 1997 70-15(3)(a)

case references
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  (1990) 21 ATC 458
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- F C of T v Solling; F C of T v
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- 11 CTBR Case 14