

# ***TR 93/20 - Income tax: computer spare parts***

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## Taxation Ruling

### Income tax: computer spare parts

#### other Rulings on this topic

**IT 333; IT 359; IT 2670;  
CITCM 497;  
CITCM 835;TR92/D34;  
TR 93/D13**

*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.*

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### What this Ruling is about

- This Ruling deals with:
  - the circumstances in which computer spare parts are trading stock of a computer supplier for the purposes of the trading stock provisions contained in Subdivision B of Division 2 of Part III of the *Income Tax Assessment Act 1936* (ITAA);
  - the proper taxation treatment for rotatable and non-rotatable computer spare parts acquired by computer suppliers for multiple purposes e.g. to sell them, to repair computer equipment, to use them under computer maintenance agreements or to use them to meet warranty obligations;
  - the appropriate taxation treatment under section 31 for computer spare parts which constitute trading stock of computer suppliers, including acceptable bases of valuation of trading stock on hand and of stock identified for scrapping;
  - what are consumables;
  - the timing of assessability of fees payable to a computer supplier under a maintenance agreement;
  - the timing of deductibility under subsection 51(1) of repair costs incurred by a computer supplier;
  - the application of the depreciation provisions in section 54 to computer spare parts held by a computer supplier;
  - the application of the capital gains and losses provisions contained in Part IIIA of the ITAA to computer spare parts held by a computer supplier;
  - the application of transfer pricing provisions.

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2. Some of the terms used in this Ruling are defined in paragraph 113.

## Ruling

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### A - Are the parts trading stock?

#### *Parts that are trading stock*

3. Spare parts held by a computer supplier are generally trading stock if they are used by the supplier in one or more of the following ways:

- (a) Direct sale to customers.
- (b) Repair of equipment, with a separate charge being imposed for the working part supplied (e.g. over-the-counter repairs).
- (c) Repair of a customer's equipment under a maintenance agreement under which a periodical maintenance charge is made but generally no additional charge is made each time a part is supplied to the customer. Under the agreement, title to a working part passes to the customer at the time of installation and title to a non-working part passes to the computer supplier at the time it is removed from the customer's equipment.
- (d) Repair of a customer's equipment under warranty. No separate charge is imposed on the customer at the time the working part is supplied. Title to a working part passes to the customer at the time it is installed and title to a non-working part passes to the computer supplier at the time of removal.
- (e) Repair to new or used computer equipment purchased for the purpose of selling that equipment.
- (f) Manufacture of computer equipment for sale.

#### *Parts that are not trading stock*

4. Spare parts held by a computer supplier are not trading stock if they are used by the supplier in one or more of the following ways:
  - (g) Repair of equipment owned and used by the computer supplier as part of its business operations (for example, in its administration, internal accounting, training)- as parts held exclusively for repairs to the capital asset of a business.

- (h) Repair of the supplier's equipment which has been rented or hired to other parties (other than under a maintenance agreement). In these cases the computer supplier retains ownership of the equipment.
- (i) Manufacture of computer equipment to be owned and used by the computer supplier in its business operations. Expenditure incurred in purchasing these parts is expenditure incurred in purchasing a capital asset and is of a capital nature.

### **B - Multiple purpose acquisitions**

5. If a person carrying on business as a computer supplier:
- (a) can identify, when acquiring a particular computer spare part, that it is acquired for purposes of manufacture, sale or exchange (i.e. a trading purpose - see paragraph 3); and
  - (b) is able to track individual parts until disposal,

it must treat that part as trading stock. Similarly, if the computer supplier can identify some other purpose for the acquisition of a particular part and is able to track it until disposal, it must apply the appropriate taxation treatment to that part.

6. In most cases, however, computer suppliers hold all spare parts in one pool regardless of their ultimate or intended use. If a computer supplier is unable to identify with certainty at the time of acquisition the ultimate intended use to which the part being acquired will be put, either of the following methods may apply at the option of the computer supplier:

**Method 1** Whether parts are trading stock of the computer supplier depends on the **dominant purpose** of the acquisition of the parts. We would accept that, as a rule of thumb, if 80% or more of the pool of parts is to be used under maintenance agreements, all spare parts held by the computer supplier may be treated as trading stock even though 20% of parts are used for non-trading stock purposes;

**Method 2** If the computer supplier maintains sufficient records to enable it to identify the actual percentage use of spare parts for trading and non-trading purposes respectively, it may treat as trading stock the percentage used for trading purposes. This method is only available if the records of the computer supplier are able to support the apportionment.

**C - Taxation treatment of parts that constitute trading stock****i -Trading stock to be valued at year end**

7. Closing stock of spare parts held by a computer supplier must be valued in accordance with section 31. The appropriate methods of valuation discussed in the following paragraphs apply to all stock on hand, whether acquired by the supplier as new stock (that is stock that has not been used before by the computer supplier in Australia), or obtained as non-working parts from customers under maintenance agreements or warranties in return for working parts or repaired parts. Non-working parts of a computer supplier which are held by another entity for repair but which are to be returned to the supplier after repair, are also to be valued as stock on hand of the supplier, if the supplier has power of disposition over the stock. In addition, except for stock identified for scrapping (refer paragraph 25) we do not accept that stock on hand at year end need not be valued simply because it is expected that it will be disposed of in the future.

8. If the computer supplier holds both new and repaired parts in one pool, it may be unable to identify precisely which parts on hand at year end are new and which are used (without physically inspecting all parts on hand). In that case, we accept that in valuing the stock on hand the computer supplier may adopt appropriate sampling techniques to identify the proportion of new and used parts in its stock. The computer supplier must be able to demonstrate, if required, that the sampling techniques adopted are properly based.

**ii -Subsection 31(1)***Market selling value*

9. Under subsection 31(1), closing stock of spare parts may be valued at cost, market selling value, or replacement price at the option of the taxpayer. Market selling value means the value which the spare part would have attracted if it had been sold in the ordinary course of the supplier's business. If the supplier sells spare parts both on a retail and wholesale basis, whether the retail or the wholesale value is the relevant market selling value depends on the individual circumstances of the taxpayer's business. For example, if the wholesale stock can be identified, it should be valued at the wholesale value and the retail stock valued at retail value. If wholesale stock cannot be identified, stock may be valued on the basis of actual percentage sales of parts by retail or wholesale, provided appropriate documentation is maintained. Alternatively, if the business is predominantly wholesale (or retail), the stock may be valued at the wholesale (or retail) value.

*Replacement price*

10. Replacement price ('the price at which it can be replaced') means the price at which the computer supplier can acquire a part in a substantially identical condition (e.g. functional condition, age, wear and tear, etc.) to the particular part in its buying market.

*Cost price*

11. 'Cost price' means the amount of money (or its equivalent) for which the trading stock is acquired. If no amount of money is paid for the trading stock, cost price is the consideration provided in return for the trading stock. Generally speaking, acceptable cost bases for valuing computer spare parts include actual cost, average cost and FIFO (First In First Out).

**(a) Rotatable parts obtained from customers- before repair**

12. A non-working part removed from a customer's equipment and held as work-in-progress (before it is repaired) may be valued in one of the following ways:

**-market selling value** - for example, if a second-hand market in the part exists, the value of a part in a substantially identical condition in that market. Market value cannot be scrap value of the part unless it can be demonstrated that the computer supplier's normal selling market for these parts is the scrap market.

**-replacement price** - this is the price at which the supplier can acquire a part in a substantially identical condition - it may be for example the replacement cost of an equivalent working part less estimated repair costs. Generally replacement price does not include the trade-in price of the part.

**-cost price** - This is the labour cost of removing the non-working part from the customer's equipment plus the amount of consideration attributable to the non-working part. Calculation of the latter amount must take into account the fact that four items of consideration move between customer and computer supplier: the supplier provides a working part and labour, and the customer pays maintenance fees on an annual basis and provides the non-working part. If a computer supplier is unable to calculate the consideration attributable to its stock of non-working parts taking into account all 4 items of consideration, an accounting treatment resulting in the part being valued as an equivalent working part less estimated repair cost is considered to give a true reflex of the taxpayer's income and would

therefore be acceptable for taxation purposes. For this purpose, it is not acceptable to adopt the written down value, i.e. the value of the part as reduced to reflect the diminution in value through age or use (less estimated repair costs). However, it is acceptable to adopt the value of an equivalent **used** working part less estimated repair costs (see example at paragraph 114 of this Ruling).

**(b) Rotatable parts obtained from customers - after repair**

13. A non-working part obtained from a customer and which has been repaired by the computer supplier may be valued in one of these ways:

**-market selling value** - for example, if a second-hand market in the part exists, the value of a reconditioned (used) part in that market;

**-replacement price** -for example, the price of an equivalent reconditioned (used) part; or

**-cost price** - for example, this may be the value of the unrepaired part plus repair costs, that is either actual repair cost for individual parts or of the parts in individual stock lines, or if it is not possible or practical to identify the actual repair cost of individual parts or lines of stock, the overall repair costs as allocated to stock lines or categories of stock (provided it is based on accepted accounting principles and appropriate documentation supporting the basis of the allocation is maintained).

**iii - Subsection 31(2)**

14. Subsection 31(2) recognises that a stock value calculated in accordance with one of the methods in subsection 31(1) is inappropriate if the stock cannot be sold or otherwise used to produce assessable income. It provides that in some cases involving obsolescence or other special circumstances, the Commissioner may determine a fair and reasonable value of closing stock lower than the lowest value reached under subsection 31(1). It is implicit in the wording of these provisions that subsection 31(2) may only apply after the lowest value under subsection 31(1) has been determined. The subsection requires that the value be fair and reasonable and be determined having regard to:

- (a) the quantity of trading stock on hand at the end of the year of income;
- (b) the quantity of trading stock sold, exchanged or used in manufacture by the taxpayer after the end of the year of

income and the prospects of sale, exchange or use in manufacture of further quantities of that trading stock;

(c) the quantity of trading stock of the same kind sold, exchanged or used in manufacture by the taxpayer during the year of income and preceding years; and

(d) such other matters as the Commissioner considers relevant.

15. Subsection 31(2) applies to rotatable and non-rotatable parts. A computer supplier electing to value closing stock in accordance with a calculation method under subsection 31(2) is required to notify the Commissioner in accordance with subsection 31(3) (refer to the final Ruling based on TR93/D13).

16. We accept that in the case of spare parts held by computer suppliers, there may be obsolescence or other special circumstances requiring the determination of a value under subsection 31(2). Obsolescence or other special circumstances must relate to the particular lines of trading stock and not simply to the taxpayer or the industry generally.

17. Obsolescence in computer spare parts is primarily due to discontinuance of the sale or manufacture of the equipment to which the parts relate. Due to its maintenance and warranty obligations, a computer supplier is required to hold computer parts for a certain number of years after the sale of the computer equipment even though the computer equipment has been superseded by later models.

18. In addition to obsolescence, the following factors may constitute special circumstances:

-due to its maintenance and warranty obligations, a computer supplier is required to maintain certain levels of spare parts to be able to satisfy those obligations but with an expectation that some of the parts will never be used. In addition, some parts may relate to equipment that is obsolete (for example, the equipment is no longer manufactured or sold),

-the need to maintain a stock of computer spares at a number of locations to be able to service customers' equipment within a specified period after the service has been requested leads to a duplication of holdings and limits the computer supplier's ability to scrap surplus stock,

-in the case of rotatable parts, although repaired parts have the same functional capacity as new parts, their value reduces over time due to the extent to which they are used and to the number of times they have been repaired,

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-on the other hand, improved reliability in a particular line of computer equipment may lead to decreased use of parts, although a contingency store of parts still needs to be maintained,

-the fact that a stock of parts is bought whenever a new item of equipment is introduced to cover expected spare parts requirements without the benefit of historic usage data may lead to overstocking.

19. As the circumstances of a computer supplier differ from supplier to supplier, it is not possible to lay down rules covering the application of subsection 31(2) to all suppliers and all situations. The application of the subsection requires consideration of the particular facts of each case and no formula is capable of application to all computer suppliers. Provided adequate documentation supporting the calculation is maintained, we accept any fair and reasonable value calculated taking into account the factors listed in subsection 31(2) and expanded upon in the final Ruling based on Taxation Ruling TR 92/D34 which deals with the principles and factors that are generally relevant to the application of subsection 31(2). The examples provided in paragraphs 115 to 121 of this Ruling are illustrative of the circumstances for either the application or non-application of subsection 31(2) in relation to computer spare parts.

20. We consider that the following considerations are particularly relevant to the application of that subsection to spare parts held by computer suppliers for use under maintenance agreements and warranties:

- technical obsolescence factors (for example, discontinuance of the manufacture or sale of the computer equipment to which the parts relate);
- economic conditions (for example, leading to reduced numbers of maintenance agreements being entered into);
- overstocking;
- level of sales/exchanges during the income year and since year end;
- the level of stock used historically;
- the age of stock on hand;
- whether stock has been scrapped since it was written down; and
- whether the stock can be used for some other income producing purpose (e.g. repair to the computer supplier's own equipment or sale on overseas markets).

21. A valuation of trading stock under subsection 31(2) may be made on a one-off basis. However, in some circumstances, a progressive write-down from a value determined under subsection

31(1) may be a fair and reasonable value for the purposes of subsection 31(2). That would be the case if the computer supplier is unable to accurately identify the amount of stock that will not be used.

22. In the case of spare parts held by computer suppliers for use under maintenance and warranty arrangements, the obsolescence factors and the special circumstances identified above can generally be correlated to the age of the parts (that is, how long the part has been held by the computer supplier) or alternatively, to usage level for individual stock lines, provided the documentation supports this approach. This is because generally a low turnover in parts indicates a lower level of demand for the items and therefore suggests that a lower value for trading stock purposes may be appropriate.

23. However, stock lines for which parts have recently been acquired (for example within the last 2 years) are not subject to the same considerations because low turnover is clearly not due to a low level of demand. Similarly, low usage levels of parts relating to recently-manufactured equipment do not necessarily suggest that a lower value for trading stock purposes is appropriate. In those cases, it is reasonable to expect that usage levels of the parts will increase over time, as the equipment to which the parts relate ages and breaks down more often.

24. If a progressive write-down is adopted, for example on the basis of age or usage, annual percentage reduction in value must be applied to individual stock lines or categories of stock lines. As stated above, although section 31 requires each article of stock to be valued, we accept a method of valuation producing aggregate stock values for individual stock lines or categories of stock lines, if the method produces a reasonable approximation to what would have been the total valuation if each article had been individually valued.

#### **Parts identified for scrapping**

25. A computer supplier may decide to scrap rather than repair a non-working part removed from a customer's equipment. This is due to cost or other factors (for example age and condition of the part or age of the equipment to which it relates). After the part has been physically disposed of, it is no longer part of the computer supplier's stock and is therefore not valued for section 28 purposes. We recognise that if the decision to scrap stock is made close to year end, it may not be possible for the supplier to physically scrap stock before the end of the year. Therefore, we accept that stock which by reason of obsolescence or other special circumstances may be valued at scrap value under subsection 31(2), may be so valued provided it is

physically scrapped within the succeeding 6 months and that adequate documentation of the scrapping is available.

**D - What are consumables**

26. 'Consumables' are items that are consumed in the computer supplier's maintenance process and that are therefore not trading stock. Spare parts are generally not 'consumables'. An item purchased for trading purposes is to be treated as trading stock rather than as a consumable, regardless of its value.

**E - Assessability of fees payable under warranty and maintenance agreements**

27. Fees payable to a computer supplier under a maintenance agreement are assessable income of the supplier in the year in which they are derived. The timing of derivation depends on the specific contractual agreements under which the fees are paid. Generally, the accruals (or earnings) method is the appropriate basis of determining the amount of income derived by a computer supplier in the business of supplying and repairing computer equipment. We consider that, under the accruals basis, a computer supplier derives income when a recoverable debt is created and the supplier is not obliged to take any further steps before becoming entitled to payment.

28. If the maintenance agreement provides for the prepayment of fees, and the receipt of the fees is subject to the contingency of the fees having to be paid back, such fees are not derived as income until the services to which the fees relate are performed or until it becomes apparent that the supplier will not be called upon to perform the services. In those circumstances, prepaid fees paid by customers of the computer supplier may be subject to the provisions of section 82KZM.

29. Proceeds from the sale of computer equipment are ordinarily derived by a computer supplier at the time of the sale. No part of the sale proceeds may be deferred on the basis of being in respect of warranty services because a warranty is essentially a term of the contract of sale. Similarly, if a computer supplier purports to enter into a separate warranty agreement, any charges under the agreement are derived as income at the time of sale of the equipment rather than over the period of the warranty. We do not accept the view that fees purported to be paid in relation to warranty services are not derived until the warranty services are provided. The reasons for that view are set out in Taxation Ruling IT 2648. In particular, if a computer

supplier is not called on to meet any warranty claims, no refund is required to be made of any part of the sale proceeds. On the other hand, in the case of a true maintenance contract, a refund may be required to be made if the contract does not run its stipulated duration or if the service is not provided.

30. Whether the maintenance services are provided under warranty or under a properly characterised maintenance contract depends on the contractual arrangements between customer and computer supplier. For example, fees purported to be payable under an agreement relating to services to be provided during the operation of the warranty period are not considered to be payable in respect of maintenance services - they are considered to be part of the sale proceeds. However, fees payable under an agreement relating to services to be provided after the expiry of the warranty period may be considered to be fees payable under a service contract. Whether the services are to be provided under a contractual warranty or under a separate maintenance agreement may be also evidenced by whether the sale price of the equipment varies depending on whether a maintenance service is provided.

31. However, if during the warranty period, a computer supplier agrees to provide to the customer maintenance services in addition to the usual statutory and contractual warranties, the consideration payable in respect of the additional maintenance services is not considered to be part of the sale proceeds (provided it is separately identified in a contract separate from the sale contract or it is separately identified in the sale contract). That may be the case if services such as end-user training and on-going 24-hour support are provided.

#### **F - Deductibility of repair costs**

32. Costs (e.g. labour and parts) incurred in carrying out repairs under a warranty or maintenance agreement are deductible under subsection 51(1) in the year in which they are incurred (for example, in the year in which the liability to pay wages arises). Estimated repair costs are not deductible if there is no presently existing liability (for example, to pay wages).

#### **G - Depreciation provisions**

33. The depreciation provisions of the ITAA do not apply to spare parts held by a computer supplier.

#### **H - Capital gains and losses provisions**

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34. Spare parts that constitute trading stock of a computer supplier are not subject to the capital gains and losses provisions of Part IIIA of the ITAA on disposal by the computer supplier (paragraph 160L(3)(a)). Profits on disposals by a computer supplier of spare parts that do not constitute trading stock are assessable income of the supplier if the disposals are made in the ordinary course of the supplier's business (subsection 25(1)). In some circumstances, profits on disposals may be subject to the capital gains provisions. If the disposals are not made in the ordinary course of the taxpayer's business, the capital gains provisions may apply.

## I - Transfer pricing provisions

35. Nothing in this Ruling is to be taken to mean that the price of parts purchased from a non-resident entity or the cost of repairs to parts or any other servicing arrangements carried out by a non-resident entity will not be subject to adjustment in accordance with the anti-transfer pricing provisions contained in the ITAA (e.g. Division 13 of Part III or the *Income Tax (International Agreements) Act 1953* and Schedules thereto, e.g., Associated Enterprises Articles).

## Date of effect

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36. This Ruling applies for years of income commencing both before and after the date on which it is issued. However, this Office does not propose to disturb the calculation of taxable income in years of income ended before the issue of this Ruling in relation to taxpayers that have received advance opinions from this Office or have reached settlements on a basis different from the approach adopted in this Ruling (see Taxation Ruling TR 92/20). In relation to those taxpayers, this Ruling applies to assessments made in respect of the first year of income beginning after the date on which the Ruling is issued, even though the settlement provided for the continued operation of the basis of settlement.

## Explanations

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### Background industry information

#### *Who are computer suppliers?*

37. Taxpayers in the computer industry carry on their business in diverse ways. This Ruling deals with those taxpayers in the computer industry that are involved in the supply and maintenance of computer

equipment and therefore have the need to hold or have access to, stocks of spare parts and facilities necessary to service computers in the event of breakdown or malfunction. A taxpayer in the computer industry may carry on all or some of the following activities: import computer equipment and parts, sell computer equipment and parts, manufacture and assemble computer equipment in Australia, manufacture component parts in Australia, provide a maintenance service for computer equipment.

38. If a computer supplier's business involves both retail and wholesale activities, it is usual for a separate wholesale entity to be established. This entity sells computer equipment and parts to the retail entity.

39. The term 'computer supplier' as used in this Ruling includes the many diverse entities operating in the computer industry.

#### *Warranties and Maintenance Agreements*

40. Generally, a computer is sold or leased to a purchaser or lessee (the customer) with either a voluntary, contractual or statutory warranty under which the computer supplier provides a warranty service (including the provision of labour and parts) for a period of time, generally 12 months, at no cost to the customer. At the expiration of the warranty, the customer may enter a maintenance agreement requiring the computer supplier to maintain the customer's equipment in good working order including the removal and replacement of defective parts when necessary. While the terms of maintenance agreements may vary, they generally provide that a defective part removed from a customer's equipment becomes the property of the computer supplier and that a working part installed by the computer supplier to replace the defective part becomes the property of the customer.

41. Generally such agreements provide that the customer pays an annual maintenance fee in return for which a repair-on-demand service is provided by the computer supplier. Unless the service is provided outside the terms of the agreement, no further charge is made when the maintenance service is provided. No charge is made for any individual parts supplied to a customer. No payment is made by the computer supplier for the defective part it receives.

42. A computer supplier obtains a part to be used in the maintenance of computer equipment in any of the following ways: by purchasing it from equipment or parts manufacturers or from other sellers of parts, by manufacturing it, by dismantling its own equipment (either new or used), or by exchanging a working part for a non-working part in a customer's equipment.

***Repair of defective parts***

43. The defective part removed from a customer's equipment is returned by the computer supplier to a central location or workshop. The part is examined and a decision is made, often in accordance with a pre-determined policy, whether or not it is to be repaired. Because of the nature of the repair process, the defective part may not be immediately repaired so that at year end a computer supplier may have a stock of defective parts on hand.

44. The repair may be carried out by the computer supplier in its own workshop, by an associated entity or by a separate entity. Once repaired, the part performs the same function for which it was originally designed and is returned to the store of parts for future use.

45. In some instances, usually if the computer supplier is a subsidiary of a foreign computer manufacturer, the defective part is sent by the computer supplier to the parent company and repaired by it. The replacement part provided to the computer supplier by the foreign parent is not necessarily the same part that was sent by the supplier to its parent for repair.

***Storage of parts***

46. Whether new, repaired or non-working, a part may be "stored" by the computer supplier in a common pool in a central location, in a number of separate locations (e.g., branches, client premises), by field engineers, in an engineering workshop, in a bond store, in a research and development facility or in transit from a supplier. Each "store" of parts could comprise a mixture of "new", repaired or non-working parts.

***Pooled parts***

47. Although a computer supplier may hold all spare parts in one pool regardless of their ultimate intended use (e.g. whether for use under warranty and maintenance agreements, hire or direct sale to a customer), the spare parts may be used in any of the following ways:

- (a) direct sale to customers;
- (b) repair to equipment of other parties where separate charge for the part is made (e.g. over the counter repairs);
- (c) repair to customers' equipment under maintenance agreements;
- (d) repair to customers' equipment under warranty;

- (e) repair to new or used computer equipment purchased for sale;
- (f) manufacture of computer equipment for sale;
- (g) repair to own equipment;
- (h) repair to own equipment which has been hired to other parties; or
- (i) manufacture of computer equipment to be owned and used by the computer supplier in its business operations.

### **General principles**

48. The guiding principle in determining the correct taxation treatment of spare parts held by a computer supplier is the ascertainment of a generally acceptable accounting method that is 'calculated to give a substantially correct reflex of the taxpayer's true income'. The admissibility of any accounting method for income tax purposes 'must depend upon its actual appropriateness' (*Carden's case - Commissioner of Taxes (S.A.) v. Executor Trustee and Agency Company of South Australia Ltd* (1938) 63 CLR 108 at 155)

49. In the case of computer spare parts held by a computer supplier, it may not be practicable to trace and maintain separate records for individual parts due to the high volume of parts and to the rotating nature of the parts. The relevant taxation issues are complicated further by the nature of the maintenance and warranty arrangements under which no separate charge is made in respect of the working parts supplied and no fee is paid in respect of the non-working part received.

50. Having regard to those particular features, we accept that there are circumstances in which a taxpayer's income has to be estimated rather than calculated and that the critical question is the appropriateness of the method of computation (*Henderson v. FC of T* (1970) 119 CLR 612; 70 ATC 4016; 1 ATR 596; per Barwick CJ at CLR 647, ATC 4018, ATR 599; *FC of T v. Cyclone Scaffolding* 87 ATC 5083, (1987) 19 ATR 674 at ATC 5088, ATR 678. In *Henderson*, Barwick CJ said at CLR 647, ATC 4018, ATR 599:

'The figure determined as that income may be the result of estimation, as well as of calculation, and its determination may involve the acceptance of opinions, expert or otherwise. In the long run, it may be the outcome of an exercise of judgment'.

### **A - Whether parts are trading stock**

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51. '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'.

### *Parts that are trading stock*

- (a) parts held for direct sale to customers; and**
- (b) parts for repair to equipment of others where a separate charge is made (e.g. over-the-counter repairs)**

52. Spare parts held by a computer supplier for the purpose of direct sale to customers are trading stock of the computer supplier because they are purchased for the purpose of sale. So too are spare parts held for use in repairing a customer's equipment where a separate charge is made for the part supplied.

53. Where a computer supplier operates retail and wholesale activities through more than one entity, if the wholesale entity acquires the parts for the purpose of sale to the retail entity and has power of disposition over the stock, the parts are trading stock of the wholesale entity (see Taxation Ruling IT 2670).

- (c) parts held for repair under maintenance agreements; and**
- (d) parts held for repairs under warranties**

54. Spare parts held for use under maintenance agreements and to repair equipment under warranty, where no separate charge is made for the supply of parts and where property in the parts passes to the customer at the time of installation of the working part in the customer's equipment, are trading stock of the computer supplier for the reasons discussed below.

55. A spare part constitutes 'trading stock' as defined in subsection 6(1) if the following elements of the definition are satisfied:

- it is produced, manufactured, acquired or purchased
- for the purposes of
- sale or exchange.

In addition, the Courts have held that an item constitutes trading stock only if it is held by the trader for sale or exchange in the ordinary course of its trade -*FC of T v. St Hubert's Island Pty Ltd* (1978) 138 CLR 210; 78 A.T.C. 4104, 8 ATR 452, per Jacobs J at ATC 4116-4117, ATR 466; *FC of T v. Sutton Motors (Chullora) Wholesale Pty Ltd* 85 ATC 4398, 16 ATR 567, at ATC 4400, ATR 570.

***'Produced, manufactured, acquired, or purchased'***

56. New parts acquired or manufactured by the computer supplier satisfy the first requirement of the definition.

57. As far as concerns rotatable parts removed from a customer's equipment and in respect of which the computer supplier makes no payment, the first requirement of the definition is also satisfied because such parts are 'acquired' by the supplier. 'Purchase' is defined in the Macquarie Dictionary to mean 'to acquire by payment of money or its equivalent; buy'. 'Acquire' is defined to mean 'to come into possession of; get as one's own'. It is implicit in the definition of 'trading stock' that acquisition can occur without the payment of money. In other words, when the computer supplier comes into possession of the non-working part, it 'acquires' the part notwithstanding that it has not paid money to the customer in respect of the part.

***'Purpose'***

58. The relevant purpose must be determined at the time of acquisition or purchase. It need not be the sole or even dominant purpose (*John v. FC of T* 89 ATC 4101, (1989) 20 ATR 1, at ATC 4107, ATR 8)

***'Sale or exchange'***

59. Installation of parts in a customer's equipment under warranty or under a maintenance agreement is an exchange. The Macquarie Dictionary defines 'exchange' as 'the act or process of exchanging' and 'to exchange' as 'to part with for some equivalent; give up (something) for something else'. Because the supplier gives up the working part in return for the customer's defective part, it has exchanged it.

60. We do not accept that the term 'exchange' connotes strict economic equivalence because we consider that parties may be motivated to exchange items by considerations other than objective economic value. For example, they may be motivated by their subjective assessment of the value each places on the items.

61. However, if a computer supplier acquires spare parts for other than the purpose of sale or exchange, the parts are not trading stock. For example, that would be the case if the computer supplier acquired the stock from a related company as part of its international strategy to deal with surplus parts rather than for trading purposes. In that case, the expenditure incurred in acquiring the stock would be considered to

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have been incurred for other than income-producing purposes, and would therefore not satisfy the positive requirements of subsection 51(1) and not be an allowable deduction.

***'In the ordinary course of its trade'***

62. In *St Hubert's Island*, Jacobs J stated at ATC 4116-4117, ATR 466:

'There must be a relationship between the property and the business whereby it can be said that the property bears the description of one or another of the kinds innumeralated, not in a general sense, but in specific relation to the business which was or is carried on. Thus property, being trading stock, must be an asset of a business of trading in that stock.'

A similar view was adopted by the Full Court of the High Court in the *Sutton Motors* case at ATC 4400, ATR570, and in *John*.

63. In the *Memorex* case, in deciding whether amounts received on the sale of previously leased equipment were of an income nature, rather than of a capital nature, the Full Federal Court considered whether the sale of leased equipment was part of the taxpayer's business and said at ATC 5043:

'The evidence shows that the usual method of distribution undertaken by the applicant was distribution by sale but that during the years in question, sometimes with more enthusiasm than at others, the applicant offered to its customers the option of purchase or lease of the computer equipment....The evidence shows that the applicant had only one business, that of distributing computer equipment, the distribution involving not only the supply of equipment but also advice as to the nature of the equipment required, the design of equipment packages and the service of the equipment when supplied.'

64. Whether a taxpayer is a trader in the goods which are claimed to be trading stock is a question of fact and that depends on questions of impression and degree (*John* at ATC 4107, ATR 8).

65. We consider that the business of a computer supplier engaged in retailing and servicing computer equipment includes both the sale and maintenance of computer equipment, including the replacement of defective parts. The concept of trading stock as interpreted by the Federal Court in *Memorex* does not require a supplier's sole business to be that of dealing or trading in spare parts for the parts to constitute trading stock. In particular, the concept of trading stock may import some of its meaning from the reference in the definition to 'exchange'

as well as to 'sale'. Therefore, even if a computer supplier as part of its business enters into maintenance agreements, which may properly be characterised as contracts for labour and materials rather than contracts for sale of goods, this is not sufficient to conclude that spare parts do not constitute trading stock.

66. If a computer supplier's business includes the exchange of working parts in return for non-working parts, the supply of working parts is more than merely incidental to the business. In other words, as part of its retailing business, the computer supplier provides a maintenance service, an integral part of which is the supply of spare parts. While the maintenance fee charged by the supplier to individual customers may not directly reflect the expected cost of both labour and parts, implicit in the pricing mechanism adopted by the computer supplier is the fact that the overall amount of maintenance fees imposed on customers must take into account the cost of both labour and parts.

67. The definition of trading stock is an inclusive one. Spare parts may constitute 'trading stock' under the ordinary meaning of this expression even if they fall outside the scope of the definition (*St Hubert's Island*). We consider that spare parts held by a computer supplier for use to repair computer equipment under warranty and under maintenance agreements constitute trading stock according to the ordinary meaning of that expression because they are held for disposal in the carrying on of the computer supplier's business. This is so even though they may not be acquired for 'sale' in the sense in which that term is understood under general contract law.

#### ***Parts that are not trading stock***

##### **(g) parts for repair to own equipment**

68. These parts are held exclusively for repairs to the capital assets of a business and do not constitute trading stock (*Guinea Airways Ltd v. FC of T* (1949-1950) 83 CLR 584) because they are not acquired for the purpose of sale or exchange.

##### **(h) parts for repair to own equipment which has been hired to others**

69. These parts are installed in equipment which remains property of the computer supplier during the hire period. They are not trading stock because they are not acquired for the purpose of sale or exchange. These parts remain the property of the computer supplier after they are installed in the computer equipment which has been hired.

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## B - Multiple purpose acquisitions of parts

70. Stocks of spare parts are generally held by a computer supplier in one pool regardless of their ultimate use and their ultimate use may not be known at the time of acquisition. The question which arises is whether the same income tax consequences apply to all spare parts held by a computer supplier regardless of the actual or intended use and of the potential conflict between two possible classifications of the spare parts.

### *Dominant purpose test*

71. Two Australian Court decisions are relevant to this issue. In *Memorex Pty Ltd v. FC of T* 87 ATC 5034, (1987) 19 ATR 553, the Full Federal Court of Australia considered whether amounts received on the sale of previously leased property were receipts of a capital rather than income nature. Davies and Einfeld JJ stated at ATC 5044, ATR 563:

'The subject goods were part of the goods in which the applicant was dealing. When it was profitable or financially convenient to do so and the customer agreed, the goods were leased, rather than sold outright. But they were destined for sale or other disposal by the taxpayer sooner or later, either to the customer, another customer, an overseas affiliate or perhaps if they had no value at all, by scrapping'.

72. While distinguishing the *Memorex* decision on its facts, the Full Federal Court considered a similar issue in the *Cyclone Scaffolding* case. The case raised the question whether equipment purchased by a hirer of scaffolding equipment who also occasionally sold such equipment, constituted trading stock. At ATC 5088, ATR 678, Bowen and Beaumont JJ said:

'it is not practicable to identify, and therefore to trace, the commercial history of each item of equipment. It follows that an exercise in estimation of income rather than its calculation, in the strict sense, is called for. There is nothing novel in this. A "substantial" or by and large approach is sometimes the best that can be done'.

### *Percentage basis*

73. In *Cyclone Scaffolding*, the Court also suggested that an alternative method may be appropriate, namely the apportionment on

the basis of percentages calculated on figures of past years. At ATC 5088, ATR 679, Bowen and Beaumont JJ said:

'If a new system were to be devised, one which might be suggested is that the figures which showed the relationship of items for which money is received on disposal as against items used truly as plant in the hiring business could be quantified in some way as a percentage. For example, on a basis of estimation from the figures of past years, it might be said that X% of equipment purchased by the company ... should be treated as trading stock and Y%...should be treated as plant'.

However, their Honours recognised that it might prove impracticable to arrive at appropriate figures.

74. We consider that in the case of computer spare parts held by a computer supplier, the dominant purpose test is appropriate to characterise stocks of spare parts for multiple purposes held in one pool (adoption of the dominant purpose test of characterisation of spare parts held for multiple purposes is also supported by Prof. R.W. Parsons in *Income Taxation in Australia*, 1985, p.798). We accept, however, that if a supplier is able to determine relevant percentages of spare parts held for different purposes, it is open to it to apply the alternative apportionment method described in the *Cyclone Scaffolding* case.

75. Appropriate records to support the use of the dominant purpose or the apportionment method must be maintained by the computer supplier. As with other references in this Ruling to the maintenance of appropriate or adequate records or documentation to support a particular approach, what amounts to appropriate or adequate records will depend on the particular circumstances and accounting and stock control systems of the computer supplier.

#### **C - Taxation treatment of spare parts which constitute trading stock of the computer supplier.**

76. The appropriate taxation treatment of trading stock is determined by the operation of subsections 51(2) and (2A), and sections 28 to 37. Sections 28, 29 and 31 are particularly relevant to spare parts which constitute trading stock of the computer supplier. Subsection 51(2) precludes expenditure incurred in the purchase of trading stock from being characterised as capital expenditure or as expenditure in the nature of capital, which is not deductible under subsection 51(1).

77. Section 28 requires that the value of trading stock on hand at the beginning and at the end of a year of income be taken into account in ascertaining a taxpayer's taxable income. In particular it requires that

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any excess of the value of closing stock over the value of opening stock be included in assessable income. It also provides that any excess of the value of opening stock over the value of closing stock is an allowable deduction. The practical effect of the section is that a deduction for the cost of stock (which is allowed under section 51) is deferred until the year of income in which the stock is disposed of.

### *Trading stock on hand*

78. Spare parts held by a computer supplier for use under maintenance agreements or warranty arrangements are considered to be no longer on hand when they are installed by the computer supplier in a customer's equipment (see Taxation Ruling IT 2670).

79. Stock transferred by a computer supplier that is a company from one division of the company to another division or area of the company is not disposed of. It must continue to be valued at year end as trading stock on hand.

80. Non-working parts of a computer supplier which are held by another entity for repair and which are to be returned to the computer supplier after repair are to be valued as stock on hand of the supplier even though they are not in its physical possession (refer to Taxation Ruling IT 2670). This is so even if the other entity agrees to return to the supplier an identical working part rather than the original part. In that case, the replacement part is for all practical purposes the same as the original part. We accept that, in those circumstances, if the computer supplier makes or receives no payment in relation to the parts exchanged (other than the repair cost), the replacement part may be treated as the original part for taxation purposes .

### **i - Subsection 31(1)**

81. Under subsection 31(1), a taxpayer may elect to value closing stock on the basis of cost price, market selling value or replacement price. Although a taxpayer may change the basis of valuation of closing stock in any year under section 31, section 29 requires the opening stock value in one year of income to equal the closing value of stock in the previous year.

82. We accept that although section 31 requires each item of trading stock to be valued, a valuation method may be used provided it produces a reasonable approximation to what would have been the total valuation if each article had been individually valued (see Taxation Ruling IT 2289). Generally this means that a valuation of stock line by line will be sufficient to provide a realistic value of a taxpayer's overall stock.

83. While subsection 31(1) allows the taxpayer to choose any one of the three methods listed to value its stock, there may be circumstances in which one of the three methods is not appropriate to the taxpayer's specific circumstances (*St Hubert's Island*, per Stephen J, CLR 218, ATC 4107), for example if the result produced by the particular valuation method would deny business reality (*Parfew Nominees Pty Ltd v. FCT* 86 ATC 4678).

*Market selling value*

84. Market selling value 'contemplates a sale or sales in the ordinary course of the company's business - such sales as are in fact effected' (*Australasian Jam Co. Pty Ltd v. FCT* (1953) 88 CLR 23 at 31, 10 ATD 217 at 221, per Fullagar J). It does not contemplate a sale on the most disadvantageous terms conceivable. If there is any uncertainty as to whether or not the sale of any particular item will ever be effected, market selling value is an inappropriate basis of valuation. Similarly, if it is difficult to attribute a market selling value to the trading stock other than on an arbitrary basis, another basis of valuation under section 31 must be adopted (*W110* 89 ATC 870, 20 ATR 4143).

*Replacement price*

85. The expression 'the price at which it can be replaced' means the amount which the taxpayer would have to pay in its buying market in order to replace a substantially identical article in its stock on the last day of the buying period (Canberra Income Tax Circular Memorandum No.497, Taxation Ruling IT 2648).

*Cost price*

86. The expression 'cost price' is defined in the Macquarie Dictionary as 'the price at which a merchant buys goods for resale'. 'Price' has a number of meanings, from 'the sum or amount of money or its equivalent for which anything is bought, sold or offered for sale' to the broader meaning of 'that which must be given, done, or undergone in order to obtain a thing'. The term 'cost' is defined in the Shorter Oxford English Dictionary as 'that which must be given in order to acquire, produce or effect something; the price paid for a thing'. Although the terms cost, cost price, price encompass the concept of an amount of money paid, they are sufficiently broad to include anything given to obtain something else.

87. In the words of the majority of the High Court in *John's* case at ATC 4110, ATR 12:

'The notion of cost is not restricted to expenditure in the sense of the price actually paid for or an outgoing actually incurred in an

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acquisition. It is apt to include that forgone in exchange for that which was acquired...'

88. In considering the cost of manufactured trading stock in *Phillip Morris v. FC of T* 79 ATC 4352, 10 ATR 44, Jenkinson J of the Supreme Court of Victoria said at ATC 4360, ATR 52:

'The concept expressed by the words 'cost price' in sec.31(1) in my opinion is, in its application to an article of trading stock manufactured by a taxpayer, directed to ascertainment of the expenditure which has been incurred by the taxpayer, in the course of his materials purchasing and manufacturing activities, to bring the article to the state in which it was when it became part of his trading stock on hand.....Analogy between acquisition by purchase, which the expression 'cost price' plainly contemplates, and acquisition by manufacture suggests as much, although the analogy is imperfect ...'

89. The *Philip Morris* decision that absorption costing rather than direct costing is the correct method for valuing the cost of manufactured trading stock is an expression of the broader principle that cost price is not to be given a narrow interpretation and that it encompasses the cost of the stock to a taxpayer, including expenditure in getting it to its existing condition and bringing it where it is on hand.

90. That the expression 'cost price' as used in the context of the trading stock provisions is to be given a broader meaning is supported by the fact that the definition of 'trading stock' specifically refers to items acquired for the purpose of 'exchange' and therefore envisages that the cost price method of valuation applies even if the consideration is not in the form of money.

91. For example, in a barter or countertrade transaction, the notion of cost price does not relate to expenditure actually paid or outgoing actually incurred (which would be nil) but rather to what was foregone in return for that which was acquired. It would be incorrect to assert that the cost of trading stock acquired in a barter transaction was nil because no expenditure or outlay had been incurred.

92. In addition, subsection 21(1) provides that 'where, upon any transaction, any consideration is paid or given otherwise than in cash, the money value of that consideration shall, for the purposes of this Act, be deemed to have been paid or given'. 'Consideration' is defined in *Halsbury's Laws of England* (paragraph 310, vol.9) as 'some right, interest, profit or benefit accruing to the one party, or some forbearance, detriment, loss, or responsibility given, suffered, or undertaken by the other at his request. It is not necessary that the promisor should benefit by the consideration. It is sufficient if the

promisee does some act from which a third person benefits, and which he would not have done but for the promise'. In the trading stock context, this means that if consideration for trading stock is given otherwise than in cash, the cost of that trading stock that has been acquired is the money value of the consideration provided.

93. Our view of the scope of the expression 'cost price' is not inconsistent with the statement by Fullagar J in *Australasian Jam* that 'cost' means 'actual cost'. That statement is to be read in the context of His Honour's rejection of the taxpayer's valuation of stock based on what was 'in effect a "standard" or more or less arbitrary "value" '.

**(a) Rotatable parts obtained from customers' equipment-before repair**

94. The valuation of non-working parts removed from customers' equipment depends on the individual circumstances of each case. For instance, the computer supplier may adopt market selling value (for example, if a second-hand market in the parts of the supplier exists, the value of a part in a substantially identical condition in that market) or replacement price (i.e. the price at which the supplier can acquire the part in a substantially identical condition. For example, it may be the replacement cost of an equivalent used working part less the estimated cost of repair).

95. We do not accept the contention that the expression 'cost price' refers solely to actual outlays or expenditure incurred and that therefore the 'cost price' of a non-working part for the purposes of subsection 31(1) is zero because the computer supplier does not pay a specific amount to the customer in respect of the removed part. As discussed above, the notion of 'cost price' is sufficiently broad to encompass that which is forgone for that which is received. We consider that when a non-working part is obtained in exchange for a working part, the parts exchanged provide part of the consideration moving between computer supplier and customer and that section 21 applies to deem the money value of the consideration to be the cost of the stock.

96. Having established that the cost price of non-working parts is not limited to outlays incurred in obtaining the parts, the amount of consideration attributable to the non-working parts must be ascertained by taking into account all 4 items of consideration that pass between computer supplier and customer under a maintenance agreement: the supplier provides a working part and labour, and the customer pays maintenance fees on an annual basis and provides the non-working part. While we accept that the non-working part cannot be ascribed the value of the working part provided in exchange without adjustment, we consider that that value is to be taken into account in calculating the cost price of the part obtained.

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97. In addition, the cost to the computer supplier of bringing the non-working part into its trading stock will include the labour cost of removing the part from the customer's equipment.

98. If a computer supplier is unable to calculate the cost price of its stock of non-working parts by taking into account the 4 items of consideration, the cost price of unrepaired parts based on the appropriate accounting treatment may be acceptable for taxation purposes. In *Carden's* case, in discussing which accounting method was most appropriate to determine the amount of income derived, the High Court said at p.155:

'Unless in the statute itself some definite direction is discoverable, ...the admissibility of the method which in fact has been pursued must depend upon its actual appropriateness. In other words, the inquiry should be whether in the circumstances of the case it is calculated to give a substantially correct reflex of the taxpayer's true income.'

99. In the present case, an accounting treatment resulting in the part being valued as an equivalent used working part less estimated repair cost is considered to give a true reflex of the taxpayer's income and would therefore be acceptable for taxation purposes. It has been argued that in reaching the cost price of an unrepaired part by adopting such an accounting treatment, the estimated repair cost can be subtracted from the **written down** accounting value of the part, i.e. from the value of the part as reduced to reflect its diminution in value due to age or use. We consider that such diminution in value is appropriately reflected in the value of the stock if the requirements of subsection 31(2) are satisfied. However, we consider that whereas age and use are relevant in determining a fair and reasonable value under subsection 31(2), they may not be taken into account in determining cost under subsection 31(1). We consider that a cost price arrived at by subtracting the estimated repair cost from the value of an equivalent **used** working part is acceptable for the purposes of subsection 31(1) (see example at paragraph 114 of this Ruling).

## **(b) Rotatable parts obtained from customers- after repair**

100. In most cases, when the non-working part removed from a customer's equipment is repaired, it is restored to its original functional state and is then placed in the common pool of spare parts. The methods of valuing these parts are market value, replacement price or cost price.

### *Market value*

101. This is the value of a part in a substantially identical condition in the second-hand market.

*Replacement price*

102. If the part has been restored to its original functional state, replacement price is the price of an equivalent reconditioned part.

*Cost price*

103. This is the cost of the unrepaired part (see above) plus repair costs (including both labour and parts). Repair cost alone is not an acceptable cost basis of valuing repaired parts. This is because the cost of the unrepaired part to the supplier includes the repair cost plus the cost of obtaining the unrepaired part.

104. If the computer supplier is able to identify the actual repair cost of the individual part or of the parts in a particular line of stock, that is the cost to be taken into account in determining the overall cost of the parts on hand. If it is not possible or practical to identify the actual repair cost of individual parts or lines of stock, the cost of repair may be calculated by allocating overall repair costs to individual stock lines or categories of stock. In this case, the computer supplier must use a generally accepted accounting method and maintain appropriate documentation supporting the basis of the allocation.

**D - What are consumables**

105. Items may be characterised as 'consumables' (that is, items that are consumed in the computer supplier's maintenance or repair process) by reference to their function in a computer supplier's activities or processes rather than by reference to their inherent nature. They are acquired with the intention that they will be consumed in the course of the computer supplier's business. Items are not to be characterised as consumables simply because of their financial value.

106. Consumables by their very nature are not trading stock because they are not acquired for the purpose of sale or exchange. Consumables are not exchanged at the time of repair of a customer's equipment.

107. Spare parts which are not consumed in the repair or maintenance process but rather are incorporated in the computer equipment, are not consumables.

**F - Deductibility of repair costs**

108. Costs (e.g. labour and parts) incurred in carrying out repairs under a warranty or maintenance agreement are deductible under subsection 51(1) in the year in which they are incurred (for example, in the year in which the liability to pay wages arises). Estimated repair

costs which have not been incurred are not deductible when the estimate is made.

109. It has been suggested that estimated repair costs are deductible because in the cases of *RACV Insurance Pty Ltd v. FCT* (74 ATC 4169; 4 ATR 610) and *Commercial Union Assurance Co.v. FCT* (77 ATC 4186; 7 ATR 435) the Courts decided that a reasonable estimate of insurance claims yet to be reported but nevertheless incurred was deductible under section 51. It has been suggested that, by analogy, computer suppliers are entitled to a deduction for reasonable estimates of repair costs in relation to repairs, the need for which has arisen but has yet to be notified and the performance of which is obligatory under a warranty or maintenance agreement.

110. We accept that expenses are deductible when they are incurred, that is, when there is a presently existing liability which is due, notwithstanding that they may not be quantifiable as yet (*Commonwealth Aluminium Corp. Ltd v FCT* ( 77 ATC 4151; 7 ATR 376) and that this was the basis for the decisions in the cases referred to above. However, it does not follow that an amount can be deducted for future estimated claims (in respect of which no liability has arisen). In the case of repair costs, although unreported faults may be estimated, the liability for the repair costs to the taxpayer, i.e. labour costs, has not arisen at the time the fault has been discovered by the customer. No expenditure is deductible until the liability (for example to pay wages) arises (see Taxation Ruling IT 2648). The other repair cost, i.e. the cost of parts, falls for treatment under the trading stock provisions.

### **G - Depreciation provisions**

111. Spare parts held in stock by a computer supplier may not be depreciated under the provisions of section 54 because they are held in circumstances that do not meet the requirements of that section.

Section 54 provides an allowable deduction for depreciation :

- (a) of any item of property being plant or articles
- (b) which is owned by a taxpayer and used by the taxpayer during that year for the purpose of producing assessable income or
- (c) which is owned by the taxpayer and which has been installed ready for use for that purpose and is during that year held in reserve by the taxpayer.

112. Spare parts held for use under maintenance agreements or warranties or which are otherwise trading stock are not depreciable property because trading stock and plant are mutually exclusive

categories ((1953) 3 CTBR (NS) *Case 93* at 576; *Cyclone Scaffolding* at ATC 5088, ATR 679; *Case C20 71* ATC 91). In addition, they do not satisfy the requirements of section 54 because:

- (a) it is doubtful that spare parts are 'plant' (*Guinea Airways* per Dixon J at 588);
- (b) spare parts which are in the possession of a computer supplier are not used by the supplier for producing assessable income (and in this sense 'used' means more than simply 'held') (*Guinea Airways*);
- (c) spare parts are not installed ready for use while they remain in the stock of a supplier (*Guinea Airways*). In addition, under computer maintenance agreements, ownership in a part passes to the customer when the spare part is installed in the customer's equipment. Therefore the spare part does not constitute depreciable property of the computer supplier because it is no longer owned by it.

## Definitions

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113. In this Ruling,

**consumable** means an item which is consumed by a computer supplier by use (for example, lubricating material, rags).

**non-rotatable part** means a computer spare part that is not a rotatable part, that is only used in one item of equipment and that is scrapped when it breaks down.

**parts** includes both spare parts and component parts.

**rotatable part** means a computer spare part which is repaired, restored to perform the function for which it was originally designed and rotated into a customer's computer equipment. It includes a part that has been rotated several times through different items of equipment.

## Examples

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### Cost price of parts obtained from customers - before repair

114. A computer supplier obtains a non-working part (Model 101), known to be 2 years old, from a customer under a maintenance agreement. The estimated cost of repairing the part is \$40. A new part (Model 101) costs \$200. A used working part (Model 101) costs \$100. We accept that the cost price of the non-working part at year end

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for the purposes of subsection 31(1) is \$60 (i.e. \$100 less \$40). That value may be written down subject to the requirements of subsection 31(2) being satisfied. If for accounting purposes, the part is written down to \$60 (being 2 years old), it is not acceptable for subsection 31(1) purposes to value it at \$20 (i.e. \$60 less \$40).

## Cases in which subsection 31(2) was applied

115. A sampling of the slow-moving stock line XX identified by Company A as being obsolete at the end of the 1992/1993 year of income indicates that 90% of the stock is scrapped within the following 6 months. The company may value stock line XX in its 1992/93 accounts as follows: 10% under subsection 31(1) and 90% at scrap value under subsection 31(2) on a one-off basis.

116. Company B holds spare parts relating to machine XX. The last sale of XX took place 10 years ago. No spare parts were used for repair or sale in the last 2 years and only about 10% were used in the last 5 years. While it is probable that no more parts will be used by the company for sale or in repairing customers' equipment, it is possible that another part may be required because the machines could continue in use for quite a long time if looked after properly. The parts are retained for goodwill purposes only. It is accepted that scrap value is the appropriate value under subsection 31(2).

117. Company C categorises its stock lines depending on the number of years' demand that would be satisfied with the current stock levels based on usage over the last 2 years. It then estimates the likely future usage for each stock line, depending on the number of years' demand on hand. It estimates that 90% of items for which there is over 5 years' stock on hand will never be used. Of the items for which there is 3 to 5 years stock on hand, 50% will never be used. Items for which there is 3 years stock on hand may all be used. Accordingly, it is accepted that C's estimate of likely future usage can be used to calculate the value of stock on hand (other than in stocklines for which stock have been acquired in the last 2 years) under subsection 31(2) as follows:

- (i) items for which there is less than 3 years' stock on hand: no write-down
- (ii) items for which there is between 3 and 5 years' stock on hand: 50% write-down
- (iii) items for which there is over 5 years' stock on hand: 90% write-down.

118. Company D's records of past usage identify which stock lines have experienced significant movement (i.e. over 10% of overall volume of the individual stock line) in past years. Based on past usage records, D estimates that of the lines that have experienced no significant movement over the past 5 years, 80% will never be used. Of the lines that experienced no significant movement in the last 4 to 5 years, 50% will never be used. Of the lines which had experienced no significant movement in the last 3 to 4 years, 20% will never be used. As to stock with no significant movement in the last 3 years, all could still be used. Accordingly, D values its stock (other than in stocklines for which parts have been acquired in the last 2 years) under subsection 31(2) as follows:

No significant movement

(i.e. over 10%) in the

<u>line of stock over</u>	<u>% write-down</u>
0-3 years	Nil
3-4 years	20%
4-5 years	50%
over 5 years	80%.

D's valuation is a reasonable estimate of the value of its stock based on past usage records.

**Cases in which subsection 31(2) was not applied**

119. Company F identifies surplus stock by projecting over the next 6 months the movement in each stock line (except those relating to equipment less than 12 months old) over the previous 12 months. It seeks to write off the amount of stock surplus to the next 6 months requirements. The proposed valuation method is not acceptable because it does not reflect either the age of the parts, or a substantial usage record (e.g. over 2 years).

120. Company G undertakes to supply maintenance and parts for a period of up to 5 years under annual maintenance contracts. It seeks to apply a 20% write-down for 5 years from the date of the first sale to reflect the life of the items required to be held under its agreements. The proposed write-down formula is not acceptable because its calculation does not relate to the particular circumstances of the stock itself but rather to the duration of the company's contracts.

121. Company H seeks to apply subsection 31(2) and to 'amortise' the historical cost of its whole stock of spare parts over 5 years by claiming that the parts reduced in value evenly over their 'average effective life'. It is considered that the company's approach is not open to it because it is not sufficiently related to the factors affecting the stock.

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## Commissioner of Taxation

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- ITAA 6(1) ITAA 25; ITAA 28
- ITAA 29 ITAA 31(1); ITAA 31(2)
- ITAA 51(1); ITAA 51(2); ITAA 54;  
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- ITAA Div. 13 Part III
- Income Tax (International  
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*case references*

- C of T (S.A.) v. Executor Trustee and Agency Co. of S.A. Ltd (1938) 63 CLR 108; 5 ATD 98; 1 AITR 416
- FC of T v. Cyclone Scaffolding 87 ATC 5083; (1987) 19 ATR 674
- Guinea Airways Ltd v. FC of T (1949-1950) 83 CLR 584; 9 ATD 197; 5 AITR 58
- Henderson v. FC of T (1970) 119 CLR 612 ; 70 ATC 4016; 1 AITR 596
- John v. FC of T 89 ATC 4101; (1989) 20 ATR 1
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