

# ***TR 94/10 - Income tax: valuing unidentifiable shares at cost***

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## Taxation Ruling

### Income tax: valuing unidentifiable shares at cost

#### other Rulings on this topic

**IT 185; IT 2289; IT 2548;  
TD 33**

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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. This Ruling considers the valuation of unidentifiable shares where those shares are trading stock on hand at the end of a year of income and the taxpayer elects to value the shares at cost price under subsection 31(1) of the *Income Tax Assessment Act 1936* (ITAA). In this Ruling the term 'unidentifiable shares' refers to shares which cannot be identified, either individually or as part of a certain parcel, as having been acquired on a particular date or at a particular cost.
2. The Ruling also considers how to ascertain the cost of such shares disposed of by a taxpayer, and thereby the profit or loss on disposal for the purposes of subsections 25(1) and 51(1) respectively, where the shares are not trading stock but are revenue assets e.g., shares owned by an insurance company or a bank are generally revenue assets but not trading stock.
3. In this Ruling a 'revenue asset' refers to 'an asset whose realisation is inherent in, or incidental to, the carrying on of a business. ... It is to be distinguished from a "structural asset", which forms part of the "profit yielding subject" of the business' (R.W. Parsons, 'Income Taxation In Australia' (1985), The Law Book Company Limited at page 155).
4. If a taxpayer disposes of shares acquired after 19 September 1985 which are revenue assets but not trading stock, both the CGT provisions (Part IIIA of the ITAA) and either subsection 25(1) or subsection 51(1) will generally apply - although the operation of the CGT provisions is principally residual (subsections 160ZA(4) and 160ZK(1)). Taxation Determination 33 addressed the identification of shares within a holding of identical shares under the capital gains and capital losses provisions. It concluded (at paragraph 4) that **for CGT purposes** we accept either the FIFO (first-in, first-out) method or 'the

taxpayer's selection of the identity of shares disposed of' (referred to in this Ruling as 'the nomination method').

5. This Ruling does not apply to shares owned by the trustee of a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust. Division 10 of Part IX governs the disposal of those shares. Taxation Ruling IT 2548 deals with the treatment of shares owned by the trustee of a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust as at the end of 30 June 1988.

## Ruling

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### **Shares which are trading stock on hand**

6. If the shares on hand can be actually identified and the taxpayer elects to value the shares at cost price for the purposes of the trading stock provisions, the actual cost of the shares must be ascertained.

7. If a taxpayer elects to value unidentifiable shares at cost price for the purposes of the trading stock provisions, that taxpayer may use either the FIFO (first-in, first-out) method or the average cost method to determine the cost price of those shares. Those methods are explained in paragraph 24.

8. It is generally preferable to determine average cost by continuous calculation. However, if there is a low turnover of unidentifiable shares, periodic calculation may be used provided it produces a reasonable approximation of actual cost.

### **Shares which are revenue assets but not trading stock**

9. If a taxpayer disposes of shares which can be actually identified, the actual cost of those shares must be ascertained in determining the profit or loss on disposal for the purposes of subsections 25(1) and 51(1).

10. If a taxpayer disposes of unidentifiable shares which are revenue assets but not trading stock, the cost of the shares (and thereby the profit or loss on disposal for the purposes of subsections 25(1) and 51(1)) can be ascertained by the FIFO method or by the average cost method. However, it is not possible to use the FIFO method for the purposes of subsections 25(1) and 51(1) together with the nomination method for CGT purposes.

11. Furthermore, a taxpayer cannot use a method for the purposes of subsections 25(1) and 51(1) with a method for the purposes of the CGT provisions which produces either of the following results:

- (a) a profit for the purposes of subsection 25(1) and a capital loss for CGT purposes; or
- (b) a loss for the purposes of subsection 51(1) and an even greater capital loss for CGT purposes.

12. It is generally preferable to determine average cost by continuous calculation. However, if there is a low turnover of unidentifiable shares, periodic calculation may be used provided it produces a reasonable approximation of actual cost.

13. In summary, a taxpayer may use one of the following combinations of methods in respect of the disposal of a number of unidentifiable shares:

- (a) FIFO for the purposes of subsections 25(1) and 51(1) and FIFO for CGT purposes; or
- (b) average cost for the purposes of subsections 25(1) and 51(1) and FIFO for CGT purposes; or
- (c) average cost for the purposes of subsections 25(1) and 51(1) and the nomination method for CGT purposes.

*provided that* the combination does not produce either of the following results:

- (d) a profit for the purposes of subsection 25(1) and a capital loss for CGT purposes; or
- (e) a loss for the purposes of subsection 51(1) and an even greater capital loss for CGT purposes.

## **Date of effect**

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14. This Ruling generally applies to years of income commencing both before and after its date of issue.

15. However, the ATO provided some private rulings in respect of shares which are revenue assets but not trading stock which said, contrary to this Ruling, that taxpayers could use the nomination method for the purposes of subsections 25(1) and 51(1). If a taxpayer received a private ruling permitting the nomination method, this Ruling disapproves the nomination method only for disposals of shares on or after 1 May 1994. This is subject to the exception that a public ruling cannot withdraw an earlier inconsistent legally binding

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private ruling if the year of income to which the private ruling relates has already commenced (see Taxation Determination TD 93/34).

16. Furthermore, this Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

## Explanations

### Whether shares disposed of can be identified

17. It is common for a taxpayer to acquire a number of parcels of shares in a company at different dates and different prices and then to dispose of some of those shares. The shares disposed of can often be identified as having been acquired at a particular time and at a particular cost by reference to numbers or other distinctive rights or obligations attached to them.

18. If the shares sold are not certificated and do not have distinctive rights or obligations, they cannot be so identified. In July 1989 the Australian Stock Exchange introduced the Flexible Accelerated Security Transfer ('FAST') system for the transfer of equity securities. The system involves the optional uncertification of equities which permits their transfer without the transfer of a share certificate.

19. Therefore, if a taxpayer buys a number of parcels of uncertificated shares in a company at different dates and different prices and then sells some of those shares under the FAST system, the shares sold cannot be identified as having been acquired at a particular time and at a particular cost. This is the case even if the transferor keeps detailed records of the shares it acquires and, at the time of a sale, nominates in writing that it is selling particular shares. A transferor who takes that action does not actually identify the shares sold because it is impossible to do so. The nomination is not an identification.

20. A general insurance or life assurance company may maintain a number of distinct funds which include shares. When that company acquires shares, the shares are allocated to, and belong to, a particular fund or funds. Similarly, when that taxpayer sells shares, the shares are identified as being those from a particular fund or funds. The situation is akin to a trustee of several trusts acquiring and disposing of shares of more than one trust.

21. However, if a fund includes uncertificated shares in a company acquired at different dates and different prices and the taxpayer sells part of that holding, it is not possible to identify the shares sold from

that fund as having been acquired at a particular time and at a particular cost.

22. Furthermore, there are many cases where shares sold cannot be identified even though they are certificated, especially where the shareholder no longer holds the certificates originally acquired on acquisition of the shares. For example, where a shareholder previously sold part of a holding of a number of shares represented by several certificates, the original certificates may have been surrendered and a balance certificate issued. On a later sale, the shares sold may no longer be identified as having been acquired in a particular transaction.

### **Shares which are trading stock on hand**

23. If the shares can be actually identified, the actual cost of the shares must be ascertained (*The Minister of National Revenue v. Anaconda American Brass Limited* [1956] 1 AC 85 at 101-102; [1956] 1 All ER 20 at 25-26; Taxation Ruling IT 2289 at paragraph 5).

24. A number of accounting methods are used in valuing items of trading stock on hand at cost where it is impossible or impracticable for the actual cost of each item to be ascertained. Approved Accounting Standard AASB 1019 and Australian Accounting Standard AAS 2 consider this issue but do not apply to shares. Methods which could be used to value unidentifiable shares for accounting purposes include :

- (a) FIFO (first-in, first-out) - it is assumed that the items acquired first are disposed of first.
- (b) LIFO (last-in, first-out) - it is assumed that the items acquired last are disposed of first.
- (c) average cost - each item of a particular type is assigned a weighted average cost (the average cost is weighted according to the quantity of stock purchased at each price) determined by a continuous calculation or a periodic calculation.

25. In the Canadian case of *The Minister of National Revenue v. Anaconda American Brass Limited* the Privy Council held that the FIFO method gives a true reflex of the year's income, as the income tax law requires, while the LIFO method can operate to understate income for particular income years. The Privy Council endorsed the views of the Court of Appeal in *Patrick v. Broadstone Mills Ltd* [1954] 1 WLR 158; [1954] 1 All ER 163, which rejected the base cost method for similar reasons. (The base cost method assumes that the carrying on of a manufacturing business always requires a minimum amount of stock on hand. The business values the base stock at cost

when it establishes that base and values excess stock by another method.)

26. In *Anaconda American Brass* the Privy Council also said, without having to decide the matter, that where a business deals with homogeneous material, there may be cases where the average cost method could be properly adopted. If the actual cost of trading stock cannot be ascertained, its cost can be established by the average cost method provided that it produces a reasonable approximation to what would have been the total valuation if each article had been individually valued at cost price (Taxation Ruling IT 2289).

27. Consequently, if a sharetrader chooses to value trading stock on hand at cost price we accept that it may use either FIFO or the average cost method in valuing unidentifiable shares.

28. It is generally preferable to determine average cost by continuous calculation, rather than by periodic calculation, because periodic calculation may not produce a reasonable approximation of actual cost. However, if there is a low turnover of unidentifiable shares, determining average cost by periodic calculation may be simpler without producing a misleading result.

### **The nomination method**

29. Some tax practitioners have argued that the nomination method, i.e., the taxpayer's selection of the identity of the shares disposed of, is acceptable for revenue assets and have cited clause .30 of Approved Accounting Standard ASRB 1019 in support of their case. ASRB 1019 does not apply to marketable securities (Clause .02). Furthermore, we consider that ASRB 1019 does not support the nomination method for items of trading stock which are not marketable securities.

30. Clause .30 of ASRB 1019 says that the cost of inventories may be assigned to particular items of inventory by the 'specific identification' method. Paragraph (xv) of the commentary on ASRB 1019 says that the specific identification method 'assigns specific costs to **identified** units of inventory' (our emphasis). ASRB 1019 does not say that the specific identification method is an appropriate method to allocate costs to assets which cannot be identified.

31. In any event, *The Commissioner Of Taxes (South Australia) v. The Executor, Trustee and Agency Company of South Australia Limited (Carden's Case)* (1938) 63 CLR 108, *Anaconda American Brass* and *Broadstone Mills* demonstrate that methods which are acceptable for general accounting purposes may be unacceptable for the purposes of income tax laws imposing tax on an annual basis.

We consider that the nomination method is not an acceptable method to value unidentifiable shares which are trading stock.

32. Like the LIFO method considered in *Anaconda American Brass*, the nomination method can operate to understate taxable income in particular income years. For example, a taxpayer could consistently nominate that it sold the highest cost shares, thereby minimising the value of stock on hand at the end of the income year and taxable income. Furthermore, like the LIFO method, if a business continues and trading stock is carried forward, substantial purchases may not come into account for many years, if ever, in ascertaining taxable income.

33. Consequently, the nomination method is not 'calculated to give a substantially correct reflex of the taxpayer's true income' (*Carden's Case* at 154).

### **The CGT provisions**

34. Part IIIA does not apply to a disposal of an asset if throughout the period when the asset was owned by the taxpayer the asset was trading stock of the taxpayer (paragraph 160L(3)(a)). Consequently, the issue of the interaction of the CGT provisions with other provisions of the ITAA does not arise here.

### **B. Shares which are revenue assets but not trading stock**

35. If a taxpayer disposes of shares which are revenue assets but not trading stock, the gross receipt is capital in nature but any net profit is income according to ordinary concepts and, therefore, assessable under subsection 25(1) (*Commercial and General Acceptance Ltd v. FC of T* (1977) 137 CLR 373 at 382-383; 77 ATC 4375 at 4380 7 ATR 716 at 721-722; *FC of T v. Whitfords Beach Pty Ltd* (1982) 150 CLR 355; 82 ATC 4031; 12 ATR 692; *Parsons* at pages 307 & 431-432). It follows that if the disposal results in a net loss, that loss is deductible under subsection 51(1) (*Ronpibon Tin N.L. and Tongkah Compound N.L. v. FC of T* (1949) 78 CLR 47 at 57)

36. The above principles are clearly illustrated in the cases which deal with the investments of banks and insurance companies (e.g., *Colonial Mutual Life Assurance Society v. FC of T* (1946) 73 CLR 604; *Chamber of Manufactures Insurance Ltd v. FC of T* (1984) 2 FCR 455; 84 ATC 4315; 15 ATR 599; *C of T v. Commercial Banking Co. of Sydney* (1927) 27 SR(NSW) 231). Those cases indicate that shares held by banks and insurance companies are generally revenue assets but not trading stock. Furthermore, if a bank or insurance company disposes of such shares, the gross receipt is not assessable

income. Rather, any profit on the sale of the investment is assessable income under subsection 25(1) and any loss is an allowable deduction under subsection 51(1).

37. Where a taxpayer disposes of shares which are revenue assets but not trading stock, the cost of those shares must be ascertained to determine whether there has been a profit or loss and, if so, the amount of that profit or loss.

38. The accounting methods outlined in paragraph 24 can be used not only to value trading stock on hand but also to calculate the cost of goods sold and the gross profit from trading activities.

39. For income tax purposes, it is logical that the methods which are acceptable in valuing at cost unidentifiable shares which are trading stock should also be acceptable in calculating the cost of unidentifiable shares which are revenue assets but not trading stock - at least where nothing in the ITAA suggests otherwise.

40. Where a taxpayer disposes of shares acquired after 19 September 1985 which are revenue assets but not trading stock, both the CGT provisions and either subsection 25(1) or subsection 51(1) will generally apply - although the operation of the CGT provisions is principally residual (subsections 160ZA(4) and 160ZK(1)). As stated in paragraph 4, we accept either FIFO or the nomination method for CGT purposes.

### **The FIFO and average cost methods**

41. We consider that the FIFO and average cost methods are acceptable for the purposes of subsections 25(1) and 51(1). Each method is used by accountants in calculating the cost of assets sold and is generally 'calculated to give a substantially correct reflex of the taxpayer's true income' (*Carden's Case* at 154).

### **The nomination method**

42. The nomination method is not acceptable in valuing revenue assets which are not trading stock for the purposes of subsections 25(1) and 51(1) for the same reasons it is not acceptable in valuing trading stock on hand (see paragraphs 31-33).

### **Whether a taxpayer must use the same method for both subsections 25(1) & 51(1) and the CGT provisions**

43. Here, an important question is whether it is necessary, for a particular disposal of shares, that a taxpayer uses the same method for

the purposes of both subsections 25(1) and 51(1) and the CGT provisions. In several ways it would be preferable if a taxpayer had to use the same method for both purposes. That would make keeping records and calculating the relevant gains and losses easier. It would also reduce the instances where the disposal of shares produced odd results e.g., a loss deductible under subsection 51(1) and a capital gain under Part IIIA.

44. However, the average cost method can be used for the purposes of subsections 25(1) and 51(1) (see paragraph 41) although it cannot be used for CGT purposes. The CGT provisions do not permit the average cost method because they require the determination of the date of acquisition of an asset (e.g., see subsection 160L(1)) and the relevant cost base of the particular asset (section 160ZH). The average cost method is different from FIFO and the nomination method in that average cost does not notionally identify particular shares. It merely attaches a value to the shares sold and to the shares on hand.

45. Similarly, the nomination method cannot be used for the purposes of subsections 25(1) and 51(1) (see reasons at paragraphs 42 & 31-33) although we accept that it can be used for CGT purposes.

46. Thus, it is not necessary that the method used to value unidentifiable shares at cost for the purposes of subsections 25(1) and 51(1) be the same as that used for CGT purposes. However, this does not mean that any method generally acceptable for income tax purposes may be used with any method generally acceptable for CGT purposes in relation to the disposal of the same parcel of shares. The reason is that the mismatch between the revenue provisions and the CGT provisions may be so extreme as to be inconsistent with the correct reflex of the taxpayer's income.

47. If the use of a particular combination of methods would produce a mismatch so extreme as to be inconsistent with the correct reflex of the taxpayer's income, we consider that the ITAA does not permit that combination of methods. In that case, the taxpayer must use another combination of methods.

48. Two particular instances where the mismatch is so extreme as to be inconsistent with the correct reflex of the taxpayer's income are as follows:

- (a) a taxpayer uses a method for the purposes of subsections 25(1) and 51(1) with a method for the purposes of the CGT provisions which produces a profit for the purposes of subsection 25(1) and a loss for CGT purposes; or
- (b) a taxpayer uses a method for the purposes of subsections 25(1) and 51(1) with a method for the purposes of the CGT provisions which produces a capital loss for the

purposes of subsection 51(1) and an even greater capital loss for CGT purposes.

49. Under Part IIIA, if a taxpayer disposes of an asset (other than a personal use asset), and the reduced cost base exceeds the consideration in respect of the disposal, the taxpayer incurs a capital loss equal to the excess (subsection 160Z(1)). If a taxpayer disposes of an asset which is a revenue asset but not trading stock, the reduced cost base (defined in subsection 160ZH(3)) should not include any costs which are not part of the cost for the purposes of subsection 25(1). Furthermore, the amounts which form part of the reduced cost base are not indexed.

50. Consequently, if a taxpayer disposes of an asset which is a revenue asset but not trading stock, the reduced cost base should be less than or equal to the cost for the purposes of subsections 25(1) and 51(1). Therefore, the disposal should not produce a profit for the purposes of subsection 25(1) and a capital loss for CGT purposes. For the same reason, a disposal of an asset should not produce a loss for the purposes of subsection 51(1) and an even greater capital loss for CGT purposes.

**Whether a taxpayer may use FIFO for the purposes of the subsections 25(1) and 51(1) together with the nomination method for CGT purposes for the disposal of the same parcel of shares**

51. FIFO and the nomination method not only value shares disposed of, they both notionally identify the shares sold. If the ITAA permitted the use of the nomination method for CGT purposes together with FIFO for the purposes of subsections 25(1) and 51(1), a taxpayer could be treated as having disposed of different shares for the purposes of the different provisions of the ITAA. That would be an absurd outcome which, in our view, the legislature cannot have intended. Furthermore, it would be inconsistent with the underlying assumption in Part IIIA that the asset disposed of for CGT purposes is the same as that disposed of for the purposes of subsections 25(1) and 51(1) (see especially subsections 160ZH(3) & 160ZK(1)).

52. Consequently, a taxpayer cannot use the FIFO method for the purposes of the subsections 25(1) and 51(1) and the nomination method for CGT purposes in valuing the same parcel of shares.

## Examples

### *Example 1: shares which are trading stock on hand*

53. Dealer Pty Ltd, which carries on a business of trading in shares, purchased 10,000 shares at \$2 each in Megacompany Ltd on 1 February 1990 and 20,000 shares in the same company at \$3 each on 1 May 1990. The shares were acquired under the FAST system and, therefore, no share certificates were issued to Dealer. On 1 December 1990 Dealer sold 15,000 of its Megacompany shares at \$4 each. For the sake of simplicity, there are no brokerage charges or other transfer costs in this example.

54. At the end of the year of income ended 30 June 1991 Dealer still held 15,000 Megacompany shares and it decided to value those shares at cost price for the purpose of subsection 31(1). Dealer may use either FIFO or the average cost method to value the shares.

55. Under the FIFO method, it is assumed that the 15,000 shares sold by Dealer consisted of the 10,000 shares purchased at \$2 and 5,000 of the shares purchased at \$3. Accordingly, the 15,000 shares held at 30 June 1991 have a cost price of \$3 each.

56. Under the average cost method, the average cost of the Megacompany shares after the 1991 purchase is \$2.67 (\$20,000 plus \$60,000 divided by 30,000 shares). As there were no subsequent purchases, the average cost per Megacompany share at 30 June 1991 is also \$2.67.

### *Example 2: shares which are revenue assets but not trading stock*

57. Assume the same facts as in paragraph 53 except that Risk Ltd, a general insurance company, effected the purchases and sales of the Megacompany shares. Risk is not carrying on a business of trading in shares but the shares it holds are revenue assets.

58. To calculate the profit under subsection 25(1) on the sale and any capital gain under Part IIIA, Risk may use one of the following combinations of methods:

- (a) FIFO for the purposes of subsection 25(1) and FIFO for CGT purposes; or
- (b) average cost for the purposes of subsection 25(1) and FIFO for CGT purposes; or
- (c) average cost for the purposes of subsection 25(1) and the nomination method for CGT purposes.

**FIFO for the purposes of subsection 25(1) and FIFO for CGT purposes**

59. For the purposes of subsection 25(1), the cost of the shares sold on 1 December 1991 is \$35,000 (10,000 @ \$2 plus 5,000 @ \$3) and the profit assessable under subsection 25(1) for the year of income ended 30 June 1991 is \$25,000 (\$60,000 - \$35,000).

60. Under Part IIIA, 10,000 of the shares sold have a cost base of \$2 each and 5,000 have a cost base of \$3 each. But for subsection 160ZA(4), there would be a capital gain of \$2 on each of 10,000 shares and a capital gain of \$1 on each of 5,000 shares (i.e., a total capital gain of \$25,000). However, subsection 160ZA(4) deems there to be no capital gain because in respect of each disposal the 'notional capital gain' does not exceed the amount of assessable income under subsection 25(1).

**Average cost for the purposes of subsection 25(1) and FIFO for CGT purposes**

61. Under the average cost method, the cost of the shares sold is \$40,050 (15,000 @ \$2.67) and the profit assessable under subsection 25(1) is \$19,950 (\$60,000 - 40,050).

62. Under Part IIIA, 10,000 of the shares sold have a cost base of \$2 each and, but for subsection 160ZA(4), there would be a capital gain of \$2 on each of 10,000 shares. Subsection 160ZA(4) deems the amount of the capital gain on each of these shares to be \$0.67 (\$2 - \$1.33) because the notional capital gain (\$2) exceeds the amount (\$1.33) included in assessable income under subsection 25(1).

63. 5,000 of the shares sold have a cost base of \$3 each and, but for subsection 160ZA(4), there would be a capital gain of \$1 on each of 5,000 shares. However, subsection 160ZA(4) deems there to be no capital gain because in respect of each disposal the 'notional capital gain' (\$1) does not exceed the amount of assessable income under subsection 25(1) (\$1.33).

64. Thus, the total amount of capital gains on the disposal of the shares is \$6,700 (10,000(\$0.67)).

**Average cost for the purposes of subsection 25(1) and the nomination method for CGT purposes**

65. Under the average cost method, the cost of the shares sold is \$40,050 (15,000 @ \$2.67) and the profit assessable under subsection 25(1) is \$19,950 (\$60,000 - 40,050).

66. For the purposes of Part IIIA, Risk nominated that it sold 15,000 of the shares bought on 1 May 1990 at \$3 each. Each of these shares has a cost base of \$3 and, but for subsection 160ZA(4), there would be a capital gain of \$1 on each of the 15,000 shares. However, subsection 160ZA(4) deems there to be no capital gain because, in respect of each disposal, the 'notional capital gain' (\$1) does not exceed the amount included in assessable income under subsection 25(1) (\$1.33).

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### Commissioner of Taxation

20 February 1992

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#### ATO references

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#### *subject references*

- average cost
- cost price
- first in, first out
- Flexible Accelerated Security Transfer System
- last in, first out
- losses
- nomination method
- profit
- revenue assets
- shares
- trading stock
- unidentifiable shares

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- ITAA 25(1); ITAA 31(1);  
ITAA 51(1)

#### *case references*

The Minister of National Revenue v. Anaconda American Brass Limited [1956] 1 AC 85; [1956] 1 All ER 20  
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C of T v. Commercial Banking Co. of Sydney (1927) 27 SR(NSW) 231  
The Commissioner Of Taxes (South Australia) v. The Executor, Trustee and Agency Company of South Australia Limited (Carden's Case) (1938) 63 CLR 108  
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