Chapter 3

TRADING STOCK AND SIMILAR ASSETS

A case for reform — *127*

What is trading stock? 127

How is trading stock taxed at present? 127

A strategy for reform — *128*

Limit the flexibility in valuation of trading stock 128

Key policy issues — *128*

How should trading stock be valued? 128

What should be the treatment of assets with trading stock characteristics? 129

A case for reform

What is trading stock?

3.1 Trading stock for income tax purposes includes anything produced, manufactured or acquired that is held for the purposes of manufacture, sale or exchange in the ordinary course of a business.

3.2 The accounting concept of *inventories* is similar to that used in the tax law. The principal difference is that trading stock for tax purposes includes livestock — accounting has a separate standard for livestock and other living assets (Australian Accounting Standard AASB 1037, applicable to financial years ending on or after 30 June 2000).

How is trading stock taxed at present?

Current arrangements are inconsistent and allow excessive flexibility

3.3 Trading stock on hand at the start of the period and trading stock on hand at the end of the period are taken into account in working out a taxpayer's taxable income. Where the value of closing stock exceeds the value of opening stock the amount of the excess is assessable income. Conversely, where the value of opening stock exceeds the value of closing stock, the amount of excess is deductible. The calculation of the effect of changes in trading stock on assessable income does not need to explicitly take into account purchases or manufacture of trading stock during the year. However, the cost of purchasing or manufacturing trading stock is effectively deductible and the value of such trading stock is effectively included in assessable income. The net effect on assessable income is zero.

3.4 Income tax law currently provides taxpayers with the annual option of valuing each item of trading stock at its cost, its market selling value or its replacement price.

3.5 Taxpayers can elect the basis of valuation for each item at the end of each period. This allows them a high degree of flexibility to adjust timing of income for tax purposes.

3.6 By comparison, accounting standards (AASB 1019) require inventories to be valued at the lower of cost or net realisable value (broadly, expected proceeds of sale less, where applicable, all further costs to the stage of completion and less selling costs). Thus, under the accounting approach,

losses are brought to account as they accrue whereas gains are brought to account only at the time of realisation.

3.7 A further issue is that a number of assets with some similar characteristics to trading stock are taxed on different bases.

How do other countries tax trading stock?

3.8 *An International Perspective* (pages 78 to 80) found that most jurisdictions bring trading stock to tax on the basis of either cost or the lower of cost and net realisable value. Several countries allow switching between methods and specific rules for inventory valuation. In some cases, switching is only permissible where there is economic or commercial justification and where it does not occur frequently.

A strategy for reform

Limit the flexibility in valuation of trading stock

3.9 In valuing their trading stock for tax purposes, taxpayers can choose between cost, market selling value or replacement price.

3.10 An option for reform could be to require all trading stock to be valued on a consistent basis. If alternative methods were allowed, taxpayers could select their method of valuation but could only change at a later date if they made a case on non-tax considerations.

Key policy issues

How should trading stock be valued?

Option 1: Apply the accounting approach

3.11 Option 1 would adopt the accounting approach that generally requires inventories to be valued at the lower of cost or net realisable value. Broadly, net realisable value is estimated selling price less estimated costs of selling. Option 1 would allow deductions for unrealised losses but deferral of unrealised gains.

Option 2: Value stock at net realisable value

3.12 Option 2 would require all stock to be valued at net realisable value. Option 2 would bring to account both unrealised gains and losses.

Option 3: Allow taxpayers to select one basis of valuation

3.13 Option 3 would allow taxpayers to select one of the current options for all stock and only allow a change in the method selected if the taxpayer could make a sound case based on non-tax considerations.

3.14 Outcomes under Option 3 would depend on the method selected. However, it is thought that few taxpayers would select the market selling value option as, unlike net realisable value, it ignores the cost of selling stock.

What should be the treatment of assets with trading stock characteristics?

3.15 There is a number of assets where expenditure on acquiring or creating the asset is immediately deductible but the increase in the value of the asset is only taxed on realisation.

Consumable stores and spare parts

3.16 Generally, expenditure on the acquisition of consumables and spares to meet operational requirements is deductible at the time incurred. However, such assets are not presently treated as trading stock and their value at year-end is not required to be brought to account for taxation purposes.

3.17 Accounting treats such assets as inventories to be valued at lower of net realisable value and cost.

3.18 Bringing consumables and spares to tax in the same manner as trading stock would achieve consistency of treatment and be more compatible with accounting standards.

Standing crops

3.19 Expenditure on planting and tending crops for sale or use in a business is immediately deductible. However, crops do not constitute trading stock until severed from the land. Accordingly, there is no requirement to bring their value to tax until either severed or sold with the land. For annual crops this treatment does not raise significant problems but for long-life crops

the current treatment would seem to provide significant tax deferral benefits that are not available to other investments.

3.20 The treatment of expenditure on acquiring standing crops varies according to the nature of the asset. If the asset is standing timber, deductions are not allowable until the timber is either felled or disposed of. Expenditure on acquiring other standing crops is generally deductible at the time incurred. In both cases, expenditure on tending the asset after acquisition is immediately deductible.

3.21 As from 1 July 1999 Australian Accounting Standard AASB 1037 'Self-Generating and Regenerating Assets' will require such assets to be valued at net market value, so bringing increases or decreases in value to account as they accrue.

3.22 One reform option that could be considered is for deductions to be deferred until the value of the crop is realised. While this may have an adverse impact on some taxpayers' cash flows, it would move the taxation treatment closer to the accounting treatment.

Mineral resources

3.23 Expenditure on extracting minerals from the land is immediately deductible. Some forms of mining (for example, strip mining) can involve significant amounts being expended on removing overburden well in excess of immediate needs. However, because the minerals do not become trading stock until severed from the land, there is presently no requirement to bring to account the year-end value of work performed.

3.24 Accounting requires value of work performed to be valued at year-end. The value of this work would be later absorbed into the value of minerals extracted.

3.25 An alternative to extending trading stock type treatment to this expenditure would be to treat the expenditure as capital and allow it to be depreciated over the life of the relevant core body.

Partly completed contracts for the provision of services

3.26 Expenditure on performing services, such as professional services and construction projects, is immediately deductible. Fees for performing those services are assessable at the time earned, and that is usually at the time of billing. Presently, taxpayers are not required to account for the value of such work in progress even though they are allowed deductions for the costs of its creation.

3.27 Where the contract outcome can be reliably estimated, accounting requires estimated profits and losses to be recognised annually. Where the contract outcome cannot be reliably estimated, accounting requires all contract costs to be expensed when incurred and revenue recognised to the extent that costs are likely to be recovered.

3.28 The degree of tax deferral involved in particular cases will obviously depend on the length of the contract. Longer contracts might be more likely to be subject to periodic payments. Levying tax on the value of work done but not yet paid for may also involve cash flow problems for taxpayers.