



Australian Government

The Board of Taxation

EXPLORING THE POTENTIAL TO ALIGN ACCOUNTING AND TAX SYSTEMS IN AUSTRALIA

the **board** of taxation
www.taxboard.gov.au

*Tax treatment of trading stock and accounting
treatment of inventories*

July 2018

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EXECUTIVE SUMMARY

The Board of Taxation (the Board) undertook a self-initiated review and considered whether there exists a compelling case for legislative reform to provide for simplification through greater alignment between the tax treatment of trading stock and the accounting treatment of inventories. The specific option explored by the Board was to amend the tax law to allow taxpayers to rely on an asset's cost, as determined for financial accounting purposes, as an optional additional valuation method for trading stock.

Following a process of targeted consultation with stakeholders and internal deliberation, the Board is of the view that the tax law should not be amended in this way. The Board considers that:

- Such an amendment would represent a systemic risk to revenue and could create integrity issues; and
- Such an amendment would not significantly reduce compliance costs for most taxpayers or enforcement costs for the ATO.

The ex officio members of the Board — the Secretary of the Treasury, John Fraser, the Commissioner of Taxation, Chris Jordan AO, and the First Parliamentary Counsel, Peter Quiggin PSM — have reserved their final views on the observations and recommendations for advice to Government.

SCOPE

In 2016 the Board commenced a self-initiated review to develop potential solutions for greater alignment of tax and accounting treatments to reduce the compliance and administrative burden of complying with two different systems for taxpayers that produce financial statements. This involved identifying specific opportunities for greater alignment between tax and accounting treatments by considering interactions between the two systems.

To investigate these matters, the Board formed a Working Group, which was chaired by Board Member Craig Yaxley and supported by Board Member Ann-Maree Wolff. The Board also received high level input from AASB staff, input from the ATO and the Treasury.

In order to determine priorities, the Working Group consulted with the ATO's Tax and Accounting Safe Harbour Working Group.

The Board concluded that broad-spectrum alignment between the accounting and tax system within Australia's current taxation framework would be neither feasible nor desirable, given the disparate purposes of the tax and accounting systems.

The tax laws provide a legal basis for raising revenue to fund Government expenditure as well as, in some cases, serving as a policy implementation tool, by intentionally creating economic incentives and disincentives to certain types of behaviour.

Accounting standards exist to guide the reporting of financial information to organisation stakeholders and support a range of decision making (e.g. in relation to investment, lending, trading transactions).

However, the Board acknowledged that there may be particular areas of the tax law where greater alignment with accounting practices can create net benefits by reducing compliance costs and improving certainty, without prejudicing tax policy objectives.

The Board considers that it is appropriate to consider such areas on a case-by-case basis to identify situations where greater alignment could be warranted and could be achieved in a simple and targeted fashion.

Based on submissions from stakeholders in the business community, the Working Group considered whether there was likely a net benefit from greater alignment between the tax treatment of trading stock and the accounting treatment of inventories.

GLOSSARY

The following abbreviations and acronyms are used throughout this report.

Abbreviation	Definition
1936 Tax Act	Income Tax Assessment Act 1936
1997 Tax Act	Income Tax Assessment Act 1997
AASB	Australian Accounting Standards Board
ATO	Australian Taxation Office

CHAPTER 1: BACKGROUND

The income tax law and the accounting treatment

- 1.1 At the outset it is noted that, generally, the issues concerning the treatment of trading stock for tax purposes and of inventory for financial accounting purposes are concerned with both the quantum and timing of recognition of gains and losses.
- 1.2 That is, the total taxable income realised on a purchase and sale of stock may or may not be equal to the accounting profit or loss realised in respect of the same transaction. In addition, the time at which the taxable income is recognised may differ from the time at which the accounting profit is recognised.

Income tax treatment overview

- 1.3 Broadly, the income tax law operates on the basis that net profits or losses on the sale of trading stock are to be returned in the year in which trading stock is sold. This is accomplished, mechanically, by:
 - allowing a deduction for purchases or costs of manufacture (as a general deduction);
 - assessing sales proceeds (as ordinary income); and
 - treating the increase in value of trading stock over an income year as assessable¹ (by operation of a statutory regime in Division 70).
- 1.4 The tax law allows a taxpayer to choose between three valuation methods (cost, market selling value, replacement value) in calculating the movement in the value of trading stock.
- 1.5 In determining the 'cost' value of an item of trading stock, taxpayers apply an 'absorption costing' basis, which recognises in the cost of stock certain warehousing, distribution and similar costs (as well as the direct cost of purchase or manufacture).

¹ and any decrease as deductible.

ATO Rulings IT2350 and TR 2006/8 provide a reflection of the Commissioner's view of what costs should be absorbed into the tax cost of trading stock.

Financial accounting treatment overview

- 1.6 The accounting for inventories (including certain discounts and rebates) is addressed by AASB 102 *Inventories*, and the recognition of revenue upon sale of inventories is specified by AASB 15 *Revenue from Contracts with Customers*. For financial accounting purposes, the timing of recognition of profits on the sale of inventory may be the same as for tax purposes (that is, when the stock is sold), although in some instances, can be different.
- 1.7 AASB 102 requires inventories to be measured at the lower of cost and net realisable value).
- 1.8 AASB 102 further requires the 'cost' of inventories to comprise the cost of purchase, conversion and other costs incurred in bringing the inventory to their present location and condition. This differs from tax law, which allows taxpayers a choice of how to value trading stock.

Option evaluated by the Working Group

- 1.9 After deliberating on submissions and representations received, the Working Group identified the following potential option for further consideration:

Valuation methodology alignment

To amend the tax law to allow taxpayers to rely on an asset's cost, as determined for financial accounting purposes, as an optional additional valuation method for trading stock, where:

- The asset is trading stock that is to be taken into account under Division 70;
- The taxpayer has audited accounts;
- The audited accounts recognise the trading stock asset as an item of accounting inventory and disclose an accounting value for that item; and
- The accounting value is determined on a 'cost' basis.

- 1.10 The potential benefits of this option could include reduced compliance costs and increased certainty for taxpayers.

Options not investigated by the Working Group

1.11 The Working Group determined that certain potential alignment approaches did not warrant more detailed consideration. Namely, following initial deliberation, the Working Group considered that the following options were unlikely to answer to the requirements of a simple and targeted amendment:

- an alignment between the tax definition of trading stock to which Division 70 applies and the range of inventories to which AASB 102 applies.

The Working Group considered that such an alignment would represent a significant departure from the underlying architecture of the income tax law, which subordinates the trading stock rules in Division 70 to a number of other regimes²;

- a mandatory, rather than elective, requirement for accounting values to be adopted for trading stock for a class of taxpayers.

The Working Group considered that such an alignment would represent a significant departure from the underlying architecture of the income tax law and would create complexity by creating classes of taxpayers differentiated by whether they have audited accounts.

1.12 The Working Group is aware that the report of the Ralph Review, *A tax system redesigned*, contained a recommendation that the tax law be changed to require trading stock be valued at the lower of cost or net realisable value (i.e. a basis aligned with accounting principles).

1.13 Whilst noting the Ralph Review's endorsement of an approach that would effectively align tax trading stock valuation with accounting principles, the Working Group observed that there were a number of key differences between that approach and the option evaluated by the Working Group, namely:

- Difference in purpose and scope - the Ralph Review recommended a mandatory default regime to reduce taxpayers' ability to make self-serving choices, whereas the Board Working Group considered an additional optional valuation methodology to increase choices and reduce compliance costs for taxpayers and administrators.
- Difference in context - the Ralph Review recommendation in respect of trading stock valuation was aligned with the broader 'tax value approach'

² Including Division 230, 275 and 420 (refer Section 70-10)

recommended by the Review. The broader tax value approach was not ultimately adopted by Government.

Review and consultation process

- 1.14 In considering the scope for greater alignment between the tax treatment of trading stock and the accounting treatment of inventories in general and whether the specific option identified had merit, the Working Group undertook targeted consultation with government agencies (including the ATO and AASB staff) and private sector businesses operating in sectors that involve significant trading stock balances and transactions.
- 1.15 The Working Group also obtained selected historical income tax return data from Treasury which related to the tax trading stock valuation methodology used by taxpayers of varying scale and legal structure.

CHAPTER 2: ANALYSIS

KEY POINTS

- A majority of taxpayers chose to value trading stock at 'cost' for tax purposes. Many already rely on financial accounting numbers to establish that cost value, and this treatment was neither contentious nor subject to regular challenge from the ATO.
- Accordingly, the Board has concluded that there is not a strong efficiency or simplicity impetus for the introduction of an additional trading stock valuation method into the tax law.
- Additional considerations – such as the treatment of trade incentives - do not support the case for legislative reform.

Background and history of existing law

- 2.1 The Working Group considered the research paper prepared by the ATO on the history of the income tax trading stock rules. The research revealed that the requirement to take the change in the value of trading stock on hand into account when computing a taxpayer's taxable income has been a feature of Australian income tax legislation since at least 1915. Valuation methodologies were first prescribed in 1918 and subsequently amended in 1922 to permit an election between cost, market selling value and replacement price. The 1922 rules were subsequently substantially replicated in the 1936 Tax Act and the 1997 Tax Act.
- 2.2 The historical review did not reveal a clear policy reason for the three particular valuation methods being selected, although it could be observed that the context in which the methods suggested that their focus was livestock, rather than goods and merchandise.

Ralph review proposal

- 2.3 The valuation of trading stock was considered as part of the Review of Business Taxation. In the Consultation Paper, *A platform for consultation*³, the options canvassed

³ <http://rbt.treasury.gov.au/publications/paper3/download/Ch3.PDF>

included adopting the accounting approach, valuing all stock at net realisable value and removing taxpayers' ability to change between valuation methods.

- 2.4 In the Review's Report, *A tax system redesigned*⁴, the recommendation was that the law be changed to require trading stock be valued at the lower of cost or net realisable value (i.e. a basis aligned with accounting principles, without direct reference to accounting standards), by default, with an election for taxpayers to instead use market selling value.

Application of existing law

Practice

- 2.5 As the trading stock valuation rules have operated in substantially their modern form since 1922, the compliance practice in the taxpayer community in respect of these rules is largely well settled, as is the ATO approach to the core rules.

- 2.6 Following the decision in *Philip Morris Ltd v FCT* 79 ATC 4352 (which supported the ATO's position), the ATO publicly released its view of the meaning of 'cost' of trading stock for income tax purposes in the 1986 Taxation Ruling IT 2350 (*Income tax : value of trading stock on hand at end of year : cost price : absorption cost*). The Ruling provided, relevantly:

5. ...there are two methods of ascertaining the cost of manufactured trading stock which are recognised for accounting purposes. The first, known as direct costing or variable costing, takes into account the cost of materials and the cost of labour used directly in the manufacturing operations. The second method, known as absorption costing or conventional costing, has regard not only to the costs of materials and direct labour but takes into account also what are known as indirect costs, e.g. factory overheads.

6. It is the official view that the absorption cost method is the correct means of ascertaining the cost of trading stock on hand at the end of a year in a manufacturing business.

- 2.7 Existing Australian accounting standards do not permit solely 'direct' costing of the sort referred to in IT 2350, and IT 2350, which dealt with taxpayers in the manufacturing industry, and which has been supplemented by the release of TR 2006/8 (*Income tax: the cost basis of valuing trading stock for taxpayers in the retail and wholesale industries*).

⁴ <http://rbt.treasury.gov.au/publications/paper4/download/Section4.pdf>

- 2.8 In computing their taxable income, taxpayers may make a number of typical trading stock related adjustments:
- adjustment for consumables (amounts of accounting inventory that are not trading stock for tax);
 - adjustment for certain rebates received (amounts received from suppliers that are income and not part of cost of trading stock for tax);
 - adjustment for costs absorbed for accounting purposes that are non-deductible for income tax purposes; and
 - adjustment for stock obsolescence provision movements.
- 2.9 The Working Group's assessment, based on consultation, was that the annual compliance cost associated with making such adjustments for established businesses that prepare audited financial accounts tends, on the whole⁵, to be low, as such businesses tend to have an established methodology and a known list of general ledger accounts that must be analysed or adjusted for on an annual basis⁶.

Disputes

- 2.10 The Working Group engaged with a number of ATO business lines to assess the magnitude of compliance costs borne by taxpayers in the form of disputes with the ATO around the valuation methodology used for stock.
- 2.11 Based on this engagement, the Working Group understands that, within the class of taxpayers that could avail themselves of the proposed optional trading stock valuation methodology (namely, taxpayers with audited accounts), taxpayers typically already rely on their financial accounts for income tax purposes and that this approach to tax trading stock valuation does not represent a regular or recurrent matter of dispute with the ATO. Indeed, disputes in relation to this matter were uncommon within this class of taxpayers.
- 2.12 This outcome is consistent with the Commissioner's observation, albeit non-binding, included in ATO's Tax Ruling TR 2006/8:

21. Use of absorption costing for inventories in accordance with AASB 102 would often produce an acceptable value of the cost of trading stock for taxation purposes.

⁵ The Board notes that some exceptions do exist within the taxpayer population.

⁶ It is acknowledged that businesses may have previously incurred some compliance costs in setting up the methodology that is subsequently being used.

Taxpayer trading stock valuation methodology approaches

- 2.13 The Working Group also reviewed selected statistical tax return disclosure data from five income years of lodgements⁷. The data showed that a significant majority of taxpayers (over 90 per cent, by number) disclosed that they chose to use the 'cost' basis for valuing their trading stock⁸.
- 2.14 This trend was evident across the section of taxpayer types (companies, trusts and partnerships) and business sizes (large, SME and micro enterprises).

Interim conclusion – efficiency grounds for proposed option

- 2.15 Based on an assessment of information presented to the Working Group as part of the consultation process and the Board's own deliberation, the Board concluded that there is not a strong efficiency or simplicity impetus for the introduction of an additional trading stock valuation method into the tax law.
- 2.16 This is because the taxation law already largely operates and is administered, in a *de facto* sense, as if the proposed valuation method were operative. Specifically, information received by the Working Group suggested that, in practice, taxpayers who were presently electing a 'cost' valuation methodology⁹ were regularly relying on financial accounting numbers to establish that cost value, that accounting-to-tax adjustments made were well understood by the taxpayer community and that this treatment was neither contentious nor subject to regular challenge from the ATO.

Additional considerations

- 2.17 The Working Group also noted that in addition to potential efficiency/simplicity outcomes, an ability for taxpayers to rely on accounting cost values in valuing trading stock could, in some circumstances, result in substantive changes to the timing of recognition of taxpayers' taxable incomes and/or create particular systemic biases on an economy-wide basis.

⁷ 2010-11 to 2014-15

⁸ For completeness, it is noted that taxpayers may use more than one method to value their trading stock. In these circumstances, taxpayers are required to disclose the valuation method that represents the greatest value.

⁹ Taxpayers not currently selecting 'cost' would be unlikely to benefit from an ability to adopt an accounting cost valuation methodology.

- 2.18 The Working Group considered these potential changes to determine whether they added to or detracted from the case for reform. A summary of the Board Working Group's views in this regard is presented below.

Trade incentives

- 2.19 In some industries it is common for suppliers to offer incentives to their customers. Such incentives can take multiple forms and include rebates, subsidies and discounts.
- 2.20 The ATO has published its views on the income tax consequences of such arrangements in Taxation Ruling TR 2009/5. The Ruling provides, relevantly:

*6. A seller may provide a trade incentive that subsidises, compensates, reimburses or rewards a buyer for carrying out activities or performing services (such as promotional services) or, in the absence of such activities or services, secures a real commercial benefit for the seller in relation to its brand or future sales of its goods. **Such a trade incentive does not relate directly to the purchase of the trading stock and does not reduce the cost of acquiring trading stock for the buyer.***

7. Where a trade incentive does not reduce the buyer's cost of acquiring trading stock, the trade incentive is ordinary income of the buyer. On the assumption that the buyer returns income on an accruals basis, the income will be derived in the income year in which it is earned.

(emphasis added)

- 2.21 The Working Group's consultation process revealed that the exclusion of such incentives from the cost of trading stock could cause misalignment between the accounting cost of the relevant stock and its tax cost for some taxpayers¹⁰ and creates added compliance costs, through the requirement to identify and quantify such incentives for each income year. For these taxpayers, adding an ability to use the cost determined under the accounting standards could eliminate the associated compliance costs. On balance, this change would also tend to reduce current taxable income by deferring the recognition timing of some incentive for recipients.
- 2.22 Whilst recognising the compliance benefit that would be available to taxpayers in such circumstances, the Working Group also noted a number of countervailing matters and consequences:
- a) Accounting standards and accounting policy – Although AASB 102.11 states that trade discounts, rebates and other similar items are to be deducted in

¹⁰ This is on the basis that the relevant taxpayers' accounting practice is to treat the rebate as a reduction to the cost of inventory.

determining the cost of an inventory's purchase, AASB 102 does not set out detailed accounting treatments in respect of different rebate types. Rather, the accounting treatment adopted by entities in respect of different rebate types may vary according to the specific nature and terms of the rebate, including the entity's history in 'qualifying' for particular rebates and the entity's accounting policy in relation thereto. It may therefore be possible that in some instances, the accounting policy for specific trade incentives and the tax treatment adopted may align.

- b) Commercial practice – taxpayers may be able to amend or re-negotiate commercial agreements to eliminate the mismatch that exists between the accounting and tax treatment of trade incentives or to eliminate the trade incentives altogether (thereby achieving the compliance cost benefits).
- c) Departure from existing tax law architecture – in recent legislative practice, where the tax law has allowed direct adoption of financial accounting values, this has occurred in situations where the financial accounting outcome is strictly prescribed by the accounting standards and/or known not to vary the result that is otherwise obtained under the tax law¹¹. The financial accounting methodology for rebates, however, is subject to the nature and terms of the rebate.
- d) Creation of systemic asymmetry – although there is not, technically, alignment between the time that an incentive amount is derived as income by the recipient and the time that it is incurred as a deduction by the provider, in practice significant alignment is expected, leading to broadly neutral expected outcomes on an economy-wide basis. Allowing the recognition of rebates received to be deferred until the relevant trading stock is sold would create a systemic asymmetry that is adverse to Revenue¹².
- e) Systemic asymmetry: behavioural effects – the existence of the asymmetry would create a risk that taxpayer behaviours could be distorted and could develop to exploit the asymmetry (e.g. tending to sales of stock at relatively higher gross prices, coupled with relatively higher incentives) to create tax deferrals.

2.23 Initial deliberations of the Working Group suggested that additional complicating issues may arise in respect of other areas of the tax law that may interact with the trading stock rules. A possible example would be the treatment of any permanently non-deductible costs that are absorbed into the cost of inventory for financial accounting purposes. Special cases such as this would likely require limitations on the use of

¹¹ Examples can be found in the elective methods provided for in Subdivisions 230-C, 230-D and 230-F

¹² Specifically, the rebate paid would be immediately deductible to the payer, but effectively not assessable to recipient until a later period.

accounting cost for income tax purposes, frustrating the ability to achieve simple and targeted alignment.

Ralph review recommendation

- 2.24 The Board considered that, absent the broader tax value approach, the case for an alignment of tax trading stock valuation to accounting inventory valuation is significantly less compelling.

Conclusion – effect of additional considerations

- 2.25 The Board concluded that, on balance, the above additional considerations do not support the case for legislative reform.
- 2.26 Specifically, the Board considers that that the context and content of the Ralph Review recommendation in relation to trading stock valuation is substantially different to that considered by the Working Group and that the compliance cost benefits that would be experienced by taxpayers in receipt of trade incentives, if the tax law were amended to provide ability to rely on accounting cost values in valuing trading stock, are outweighed by the difficulties associated with the proposal. As such, it would be more appropriate for these compliance benefits to be achieved by courses of action open to taxpayers (change in commercial arrangements, revisiting accounting policies), rather than amendment of tax legislation.