

QUESTION WE'VE BEEN ASKED QB 14/01

INCOME TAX – ADJUSTMENTS FOR TRADING STOCK (INCLUDING RAW MATERIALS) TAKEN FOR OWN USE OR CONSUMPTION

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This question we've been asked is about s GC 1.

This item replaces the item "Value of produce used" published in *Public Information Bulletin* No 29 (February 1966), at 7, which relates to assessing a farmer for produce taken from his or her farm for own consumption. The current relevance of this item was identified during a review of *Public Information Bulletins* and *Tax Information Bulletins* published before 1996. For more information about the review, see "Review of Public Information Bulletins" *Tax Information Bulletin* Vol 23, No 1 (February 2011), at 116.

This QWBA applies for the 2015 and subsequent income years.

The QWBA applies to the situation where the goods being taken for private use or consumption are, in relation to a sole trader's business, trading stock of that business. This situation should be distinguished from the situation where goods of a type normally acquired as trading stock of the business are acquired for private use or consumption, and are either acquired concurrently with trading stock or from normal suppliers of trading stock (see Example 3 below). While this item refers to sole traders, the Commissioner considers the same principles apply to partners in a partnership.

This item does not consider Fringe Benefit Tax (FBT) or the dividend rules. Different rules may apply to employers and companies. If an employer or company were to provide trading stock for free or at a subsidised rate to an employee or shareholder for the employee's or shareholder's own use or consumption then FBT or dividend issues could arise. This item also does not discuss goods and services tax (GST), but if you are a GST registered person you may need to make a GST adjustment for any trading stock taken.

Question

1. What is the income tax treatment when a sole trader takes trading stock (including raw materials) for own use or consumption?

Answer

2. A sole trader is required to account for any items of trading stock taken for own use or consumption at the market value of the trading stock.

Explanation

3. The taking of trading stock for own use or consumption means the trading stock has not otherwise been sold in the normal course of the sole trader's business. As a result, the sole trader has not derived assessable business income from disposing of the trading stock. However, the costs incurred in acquiring, growing or manufacturing the trading stock would have been included in the sole trader's deductible business expenses. Therefore, an adjustment to the sole trader's assessable business income is needed to reflect the fact the sole trader has taken some trading stock. This adjustment is provided for in s GC 1. Section GC 1 applies when:

- (1) ... a person disposes of trading stock for—
 - (a) no consideration:
 - (b) an amount that is less than the market value of the trading stock at the time of disposal.
4. When s GC 1 applies:
 - (2) The person is treated as deriving an amount equal to the market value of the trading stock at the time of disposal.
5. “Trading stock” is defined in s YA 1 for the purposes of s GC 1 as:

trading stock—

 - (a) ...
 - (b) in sections ... GC 1 to GC 3 (which relate to the sale of trading stock for inadequate consideration)—
 - (i) includes anything produced or manufactured:
 - (ii) includes anything acquired for the purposes of manufacture or disposal:
 - (iii) includes livestock:
 - (iv) includes timber or a right to take timber:
 - (v) includes land whose disposal would produce income under any of sections CB 6 to CB 15 (which relate to income from land):
 - (vi) includes anything for which expenditure is incurred and which would be trading stock if possession of it were taken:
 - (vii) does not include a financial arrangement to which the financial arrangements rules or the old financial arrangements rules apply:
 - (c) for the purposes of section GC 1 (Disposals of trading stock at below market value), has an expanded meaning as set out in section GC 1(4):
 - (d) ...
6. This definition of “trading stock” includes not only finished and partially finished goods but also (under paragraph (ii)) raw materials. Also, the definition is extended by s GC 1(4) to include an interest in trading stock:
 - (4) In this section, trading stock includes an interest in trading stock.
7. It is also important to note that s GC 1 requires the market value to be determined “at the time of disposal”.
8. The following questions arise in relation to trading stock taken for own use or consumption and s GC 1:
 - What is the “market value” of trading stock taken for own use?
 - Is taking trading stock a disposal?
 - Does the “mutuality principle” apply?

These questions are discussed below.

What is the “market value” of trading stock taken for own use?

9. “Market value” is a flexible concept and has not been legislatively defined, so it bears its ordinary meaning. The *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) defines the ordinary meaning of “market value” as:

market value ► n. the amount for which something can be sold on a given market.
10. “Market value” is a term that appears throughout the Act, with its meaning determined according to the surrounding circumstances. It was considered by the

courts, particularly in respect of its ordinary meaning, in *Hatrick v CIR* [1936] NZLR 641 at 661:

The test has been variously phrased, but in essence it calls for an enquiry as to the value at which a willing but not over anxious vendor would sell and a willing but not over anxious purchaser would buy.

11. The ordinary meaning of “market value” is the current selling value in the ordinary course of business in the relevant taxpayer’s own selling market. This is shown in *Australasian Jam Co Pty Ltd v FCT* (1953) 88 CLR 23 at 31, where Fullagar J said:

But it is not to be supposed that the expression “market selling value” contemplates a sale on the most disadvantageous terms conceivable. **It contemplates, in my opinion, a sale or sales in the ordinary course of the company’s business** — such sales as are in fact effected. Such expression in such provisions must always be interpreted in a common sense way with due regard to business realities ... [Emphasis added]

12. Accordingly, market value will be ascertained for the purposes of s GC 1 with reference to the market or markets into which the sole trader would have otherwise sold the particular trading stock in the ordinary course of their business. In instances where trading stock is sold in different markets (eg, retail and trade) the relevant market will depend on the individual circumstances of the sole trader’s business. If the trading stock is committed for sale to, or is predominately available to, a particular identifiable market, then that is the relevant market. Otherwise, trading stock available for sale in any one of several markets should be valued using a weighted average.
13. As stated, the market value at which the trading stock needs to be accounted for is the amount the particular trading stock would have fetched in the relevant market or markets in the ordinary course of the sole trader’s business. Therefore, this amount will also reflect normal business decisions to clear or exit stock lines for a variety of reasons, including seasonal factors, end of shelf-life, and fashion or technological changes.
14. Accordingly, it may be that the market value of trading stock taken for own use or consumption is at or below its cost (including having nil value). In the latter situation, the income adjustment under s GC 1 will be less than the deduction allowed for the costs of acquiring, growing or manufacturing the trading stock.
15. The High Court noted the possibility of this outcome in *Foodstuffs (Wellington) Co-operative Society Ltd v CIR* (2010) 24 NZTC 23,959 where the court considered whether s GD 1 of the Income Tax Act 1994 (a predecessor of s GC 1) applied. Simon France J in *Foodstuffs* considered there may be instances where the section “has no bite”:

[30] ... The farmer could be analysed in another way — he or she has acquired trading stock for which a deduction has been claimed; if he or she chooses to destroy the stock, it is to be deemed to be done at market value. **What that market value is will depend on the reason why it is destroyed. If, for example, it is destroyed because the stock is worthless, or because no buyer can be found, then presumably the market value is nil so s GD 1 has no bite.** If, however, it is healthy stock the farmer chooses to use for his own provision, then s GD 1(1)(a) and (b) are applicable without needing to describe the farmer as a private transferee of his or her own trading stock. [Emphasis added]

The view that no issue arises under the section because the trading stock has a nil market value was also accepted by the Commissioner in respect of perishable food that had passed its use-by date (*Foodstuffs* at [18]).

16. Another possible situation is where the trading stock taken for own use or consumption is raw materials of the taxpayer’s business and those raw materials are not normally sold in the course of that business (eg, where a café owner takes some raw materials from the café kitchen). The market value of the raw

materials cannot be readily ascertained because they are not normally sold in the course of the business. In that situation there must be some next best way of estimating the market value of the raw materials. The Commissioner accepts that in most cases the next best way of estimating market value is to look at the value at which those raw materials are being traded in an arm's length transaction in other markets. This is likely to be the market in which the sole trader acquired the raw materials. That is, the next best way of ascertaining market value in this situation is to use the current replacement price of the raw materials. Where the raw materials are perishables or otherwise have a short useful life and are being taken shortly after acquisition, the current replacement price in many cases will often be the original cost.

17. Therefore, it is important that sole traders maintain accurate records of the quantity and market value of trading stock taken at the time of taking the trading stock to avoid difficulties in determining at a later stage the market value of the items. This is especially relevant for trading stock that is subject to fluctuations in market value (eg, livestock or the fresh produce of market gardeners).

Is taking trading stock a disposal?

18. Section GC 1 applies when there is a disposal of trading stock. Ordinarily, "disposal" means the process of disposing or "to get rid of" something (see: *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011). This raises the question of whether you can dispose of something to yourself (see also the discussion of the mutuality principle from paragraph 22 below). This question is important in the context of s GC 1 as to whether there is a disposal within the meaning of s GC 1 when a sole trader simply takes trading stock rather than sells it to another party. The answer is that s GC 1 applies in these circumstances.
19. The question arose in *Foodstuffs* and Simon France J concluded that s GD 1 of the Income Tax Act 1994 did not require "disposal" to be read narrowly and adopted a meaning for the term of simply to have "got rid" of something. His Honour stated:

[12] The shares are trading stock, they have been disposed of, and the taxpayer received no money for them. That is the essence of the Commissioner's argument. Prior to cancellation the shares were worth \$2.3 million; the cancellation was a disposal and \$2.3 million is the deemed income.

[13] I do not consider there is any doubt that on its face cancellation of the shares falls within the concept of "disposal". **The holder of the shares has got rid of them; it has disposed of them. Nothing in the Act suggests that disposal is generally to be read narrowly.** [Emphasis added]

20. Simon France J concluded further that there was no requirement for there to be a purchaser of the trading stock before the section could apply:

[28] **I do not see that it matters that there is not a purchaser or transferee concerning whom an equivalent adjustment is required.** The purchaser is irrelevant to the need to adjust the accounts of the owner of the trading stock which has disposed of its property. The taxpayer bought the shares, chose to treat them as trading stock, chose to bring them within its "revenue account property" and claimed the deduction for the purchase price. When the taxpayer then chooses to dispose of the trading stock, there must be an adjustment to its tax position regardless of whether the method of disposal has further implications for a different taxpayer.

...

[30] **The fact that in many of these situations the transaction is analysed or rationalised in terms of creating a transferor and transferee (the farmer as trading stock owner and the same farmer as private consumer) does not mean that every s GD 1 situation must be capable of such analysis to properly come within s GD 1.** [Emphasis added]

21. Also, as can be seen from the court's reference to a farmer (*Foodstuffs* at [30] quoted above) it accepted the view that the section applied where a farmer consumes their own stock. The court considered the section applied by creating the fiction of the farmer as a sole trader and the farmer as a private person who is the nominal transferee of the livestock at market value (*Foodstuffs* [17] and [18]).

Does the "mutuality principle" apply?

22. Another question that may arise in this context is one involving the application of the "mutuality principle". This principle can be described as "a man could not make a profit by trading with himself". The principle was established in the leading case of *New York Insurance Company v Styles* (1889) 14 App Cas 381 (HL). It has been applied in a New Zealand context in *New Zealand Plumbers' Merchants Society Ltd v CIR* (1986) 8 NZTC 5,136 (CA) at 5,139.
23. Requiring a sole trader to account for trading stock taken for own use or consumption at market value (rather than cost price) appears to require a taxpayer to account for a profit from trading with themselves.
24. However, mutuality does not apply in this context to override the clear words of the legislation that require an adjustment at market value. This issue arose in *Sharkey v Wernher* [1956] AC 58 (HL) where their Lordships approved *Watson Brothers v Hornby* [1942] 2 All ER 506, and Viscount Simonds stated (at 70):

This decision [in *Watson Brothers v Hornby*], which your Lordships were told has ever since been adopted as the basis of assessment by the Revenue in similar cases, involves two things, first, **that the taxpayer may in certain cases be subject to a sort of dichotomy for income tax purposes and be regarded as selling to himself in one capacity what he has produced in another, and, secondly, that he is regarded as selling what he sells at market price.** [Emphasis added]

25. In *CIR v Farmers' Trading Company Ltd* [1982] 1 NZLR 449 the Court of Appeal confirmed that the conclusion reached in *Sharkey v Wernher* represented well-settled law. The court stated (at 462):

Questions as to the treatment of stock in the accounts of a trader also arise wherever there is a transfer of assets between trading account and private account. In that situation it is well settled that an assessment must be made of the value of the assets at the time they were committed to or withdrawn from the income earning activity as the case may be, and that the value must be reflected in the accounts for income tax purposes (*Sharkey v. Wernher* [1956] A.C. 58; *Bernard Elsey Pty Ltd v Federal Commissioner of Taxation* (1969) 121 CLR 119; and 5 NZTBR Case 49).

Examples

26. The following examples use simple facts to help explain the application of the principles discussed above and the consequential tax adjustments that arise.

Example 1 — Market value adjustment determined at the time of disposal

27. Peter is a livestock farmer and has a 30 June balance date. He is planning a large family gathering early in July 2015 to celebrate his daughter's 21st birthday. As part of this planning, Peter arranges for one of his cattle beasts to be slaughtered to provide food for the celebration. This occurs on 28 June 2015.
28. "Trading stock" is defined in s YA 1 as including livestock for the purposes s GC 1. Therefore, the cattle beast is treated under s GC 1 as having been disposed of at market value on 28 June 2015. Peter must return as income in his 2015 tax return the market value of the animal at the time because he is treated for income tax purposes as having disposed of it in the ordinary course of his farming business. Even though the meat was not consumed until July 2015, the time of disposal is the date on which the animal was taken from trading stock in June 2015, and not the later date of consumption.

29. The market value of the animal Peter must return as income in his 2015 tax return will be the current value of the cattle beast in June 2015 in the market in which he would have sold the animal in the ordinary course of his farming business. Peter could use the market value of similar animals he had sold at the time or rely on published schedules of livestock and sale yard prices.

Example 2 — Market value adjustment reflects normal business trading, raw materials and using averages for small value items

30. John owns a retail bakery. The bakery sells sweet and savoury baked goods that are prepared fresh each day. Due to the amount of time John spends at the bakery he often finds it easier and more convenient to eat or take home food items acquired as trading stock for the business. The items of trading stock are:
- Freshly baked goods that would have been sold in the course of the day's trading.
 - Stale and left-over baked goods that would have been unsaleable.
 - Ingredients that would have been used as raw materials in the bakery (eg, flour).
31. "Trading stock" is defined in s YA 1 for the purposes of s GC 1 as including anything produced or manufactured and anything acquired for the purposes of manufacture or disposal. This means all of the food items taken by John are treated as "trading stock".
32. John is aware that he needs to make income tax adjustments for the trading stock that he takes or consumes. Accordingly, starting on 1 April 2014 he keeps a record of the food items he takes or consumes and determines their market value. He determines the market value of the items of freshly baked goods as equal to the amount they would have usually sold for in the course of his bakery business. He determines the market value of the stale and left-over goods as nil as they could not be sold in the business and would otherwise have been dumped. This value reflects normal business trading.
33. The ingredients he takes are not usually sold in the course of the bakery business. Therefore, John needs to estimate their market value. In this case, John determines that the best way to estimate this value would be to use the current replacement cost of the ingredients. He realises that this would usually mean using the amount it would cost him to replace them. However, as the ingredients are perishables taken by him shortly after their acquisition, the cost price of each item is likely to still represent their current replacement cost. Accordingly, he uses the ingredient's cost price as his estimate of their market value.
34. John's situation involves numerous small value items of trading stock. The need to maintain these records on an on-going basis places a significant compliance burden on him. Instead, John maintains (and retains) these records for part of an income year that is a suitably representative period. From these records he determines that, on average, the market value of all trading stock he takes or consumes in a typical week is \$50. Throughout the balance of the income year the amount of trading stock John consumes or takes remains consistent with the period for which he kept records. As a result, John makes an adjustment using the average of \$50 per week. He makes an adjustment in his 2015 income tax return of \$2,600.
35. Subsequently, the Commissioner audits John's 2015 income tax return. In respect of the \$2,600 adjustment, she establishes that John has made an estimate of the adjustment required by s GC 1 using records for a suitably representative period and that he has retained these records with his business

records. The Commissioner would not seek to alter John's estimate of the adjustment required under s GC 1 after considering the following factors:

- the resources available to the Commissioner;
 - what the Commissioner would consider to be a typical amount for these types of adjustments;
 - John's good compliance history; and
 - the compliance costs involved for John to now obtain actual records for the entire year.
36. The above result is based on the stated facts. The outcome would likely be different and the Commissioner would seek further evidence if:
- John had not kept good records;
 - his previous tax compliance history had been poor;
 - the amount of the adjustment appeared unreasonable;
 - the amounts involved were significantly greater; or
 - the number of transactions was significantly less.

Example 3 — Goods acquired for private purposes

37. The following two scenarios involving a builder and a farmer illustrate different aspects of the same point concerning whether goods have been acquired as trading stock or for private purposes. Whether goods have been acquired as trading stock or for private purposes will be a question of fact that needs to be decided on a case by case basis. The Commissioner strongly recommends that a record is kept or invoices are notated at the time of purchase where goods are acquired for private purposes through the taxpayer's business.
38. During the 2015 income year, a builder constructs their private residence. The materials for this construction project are purchased on trade terms through the business's normal suppliers of trading stock. The builder pays for the materials through the business bank account with the costs charged to personal drawings in their 2015 financial accounts. The costs of the materials are not included in the builder's business purchases for the year as business expenses.
39. A farmer buys 20 steer calves for \$300 each in October 2014. Two of the calves are surplus to the farming operation's requirements and the farmer intends holding them for private consumption in the future. The two calves are identified at the time of purchase and their cost is charged to the farmer's drawings for the 2015 income year. In May and October 2016 the farmer kills the two animals identified on purchase and puts the meat in the freezer.
40. The builder and farmer have both purchased goods to be used for private purposes. The builder has acquired building materials privately from normal suppliers of trading stock. The farmer has acquired livestock privately from a normal supplier of trading stock, concurrently with acquiring trading stock.
41. In both scenarios, there was never any intention or need for those goods to be used in their businesses. Section GC 1 has no application in this situation because in these circumstances it is clear the goods have not at any time formed part of the trading stock of the relevant business. For income tax purposes, the costs of the goods purchased privately have been correctly accounted for by being debited to the taxpayers' current accounts as personal drawings.

References

Legislative references

Income Tax Act 2007, ss GC 1(1)–(4) and YA 1
Income Tax Act 1994, s GD 1(1)

Subject references

Income tax
Market value
Own consumption
Own use
Private consumption
Private use
Trading stock

Related rulings or statements

“Review of Public Information Bulletins” Tax
Information Bulletin Vol 23, No 1 (February
2011), at 116
“Value of produce used” Public Information Bulletin
No 29 (February 1966), at 7

Case references

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Farmers’ Trading Company Ltd; CIR v [1982] 1
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Hatrick v CIR [1936] NZLR 641
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CIR (1986) 8 NZTC 5,136 (CA)
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Other references

Concise Oxford English Dictionary (12th ed, Oxford
University Press, New York, 2011)