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## Public Rulings by IRB on Valuation and Withdrawal of Stock

On 3 June 2020, the Inland Revenue Board (**IRB**) issued two Public Rulings on the Tax Treatment of Stock in Trade. Public Ruling (**PR**) No 2/2020 (Part I) provides guidance on Valuation of Stock, while PR No 3/2020 (Part II) relates to Withdrawal of Stock. Together, they replace PR 4/2006. This alert explains the key issues in valuation and withdrawal of stock, and also highlights the key updates by the new PRs.



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## What is stock in trade?

Taxpayers must carry out correct valuation of their stock in trade to ensure proper ascertainment of the profits and income tax payable by the business. This includes taking into account work in progress between the beginning and end of each basis period.

Stock in trade in a business is any property a business acquires, produces or manufactures (whether moveable or immovable) in the ordinary course of business (i.e. manufacturing, selling at a profit or exchanging). The nature of the business must first be established before determining whether a particular asset is stock in trade because an asset may be a stock in trade for one business but a capital asset for another, with different tax implications altogether.



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## Valuation at market value and valuation at cost

PR 2/2020 states that the market value of an inventory (stock in trade) would be equal to its fair value or estimated selling price. Market value is defined as the price which the item would fetch if it was sold between independent persons dealing at arm's length.<sup>1</sup>

The value of stock in trade at the end of the basis period is the market value at that time. Alternatively, in the case of items which are physically tangible, a person may elect to value the stock in trade at the total cost of acquiring that item (or any materials used in its manufacture, preparation, or construction) and bringing it to its condition and location.<sup>2</sup>

<sup>1</sup> Paragraph 3.5 of PR 2/2020 and Income Tax Act 1967 (**ITA**), s 2  
<sup>2</sup> ITA, s 35(3)(a)

For stock in trade consisting of immovable properties, stocks, shares or marketable securities, the value of the stock in trade at the end of the basis period is the cost price or the market value, whichever is lower. No election is possible to value such items at cost.

Work in progress of unfinished goods should be valued either at cost or market value. Unfinished goods cannot be valued at less than cost simply because there is no actual market for unfinished goods. If there is no market for uncompleted goods which can be sold as raw material of another manufacturer, valuation should be done at cost.<sup>3</sup>

Where valued at cost, the total acquisition cost of stock in trade would include:

- (i) direct expenditure on the purchase of goods bought for resale and of materials and components used in the manufacturing process;
- (ii) other direct expenditure incurred in acquiring stock or bringing it to its existing condition and location; and
- (iii) any overhead expenditure attributable to the manufacturing process.<sup>4</sup>

### **Valuation methods**

Section 35(3) of the ITA provides the basis of valuation of stock in trade which is acceptable for income tax purposes, which may differ from generally accepted accounting principles (**GAAP**). Where a business has complied with GAAP but has adopted a method of valuation which is not acceptable for income tax purposes, an adjustment must be made in the tax computation to ensure compliance with the ITA requirements.

For accounting purposes, the net realizable value (**NRV**) is commonly used when valuing stock. However, the NRV is not acceptable for tax purposes. Instead, the market value would be equal to the fair value or estimated selling price. Where the NRV of the stock is lower than the cost, a tax adjustment has to be made as follows:

- The value of the inventory from NRV has to be reinstated to its market value; and
- The estimated cost to sell or estimated selling cost which has been deducted from the estimated selling price has to be added back in the tax computation.<sup>5</sup>

Under PR 2/2020, the replacement cost method is also unacceptable for tax purposes as it involves determining a price from a market in which traders transact (i.e. wholesale price). In some instances, traders may adopt a conservative method in valuation by adopting the anticipated price that could be obtained when a business is forced to sell the goods at a lower price or when

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<sup>3</sup> PR 2/2020, para 6.5

<sup>4</sup> *Ibid*, para 6.4

<sup>5</sup> *Id*, para 7.3(b)(v)

a business is about to cease. Thus, this method is unacceptable for tax purposes. The last in, first out (LIFO) method is also unacceptable for income tax purposes.<sup>6</sup>

### **Consistency**

Taxpayers are reminded that acceptable methods for the valuation of stock in trade or work in progress should be applied consistently. If there is a valid reason for a change (such as, to give a more accurate valuation of stock in trade at cost or market value), details of the change should be appropriately documented and disclosed in the statement of accounts and the tax computation.<sup>7</sup>

### **Cessation or transfer of business**

Section 35(5) of the ITA deals with the valuation of stock in trade on the cessation of a business. The sale price or consideration value for the trading stock sold or transferred of the ceased business would be the contract price (valuable consideration), not the market value. If a business has permanently ceased and the stock in trade of the business remains unsold, the stock in hand is valued at market value at the time the business ceased.<sup>8</sup>

### **Withdrawal of stock for own use or for other reasons**

Where an item of stock in trade of a business is withdrawn whether for own use or otherwise, the market value of the item at the time of withdrawal is treated as gross business income.<sup>9</sup> The words “for his own use” are not confined to the taxpayer using a particular asset himself. They can also apply when a company transfers an asset from its stock in trade to fixed assets without making any disposal.<sup>10</sup>

When stock in trade is transferred from one business activity to another, for use in a different business activity of the taxpayer, such withdrawal will be treated as if a transaction of sale or purchase at market value has taken place. When there is a reclassification from trading to capital or vice versa due to a change of intention of the business, the trading stock is valued at the market value.<sup>11</sup>

Where the stock in trade is withdrawn for a consideration consisting of property together with a debt and/or any cash sum, the market value of that stock in trade can be reduced by the amount of the debt and/or sum.<sup>12</sup>

The tax treatments on the amount of debt and/or cash sum and the property are as follows:

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<sup>6</sup> PR 2/2020, para 6.4(b)

<sup>7</sup> *Ibid*, para 7.3(b)(vi)

<sup>8</sup> *Id*, para 8

<sup>9</sup> ITA, s 24(2) and (3)

<sup>10</sup> See *Yoon Lian Realty Sdn Bhd v DGIR* [1994] MSTC 377 (the transfer of land by a housing developer to the fixed assets account was held to be a withdrawal of stock-in-trade for the taxpayer's own use and thus assessable to income tax)

<sup>11</sup> PR 3/2020, para 5.2

<sup>12</sup> ITA, ss 24(3)(a), 24(2)(b)(ii) and (iii)

- (a) The amount of debt would be a trade debt and is taxable when stock in trade is withdrawn;<sup>13</sup>
- (b) The cash sum would be taxable when it is received;<sup>14</sup> and
- (c) The balance would be taxed at the time the stock is withdrawn from the business.<sup>15</sup>

### Stock in trade parted with by compulsion

Effective from the year of assessment 2014, Section 4C of the ITA was introduced to provide that gains or profits from a business shall include an amount receivable arising from stock in trade parted with by element of compulsion including on requisition or compulsory acquisition or in a similar manner. The amount receivable is treated as gross business income by way of compulsory acquisition. Stock in trade comprises movable and immovable goods. Where land is the stock in trade, any compensation received for the compulsory acquisition of the land is treated as gross business income.<sup>16</sup>

### Conclusion

Through the new Public Rulings, the IRB has provided detailed clarification on the valuation of stock in trade at market/cost value, and the valuation of stock in trade upon withdrawal. It is important to note that valuation methods used in GAAP may be unacceptable for tax purposes. Hence, taxpayers are to be mindful in applying valuation methods. PR 2/2020 also emphasises the importance of consistency in the application of valuation methods from year to year, even though different valuation methods apply for different types of stock.

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<sup>13</sup> ITA, ss 24(1) and 24(3)(b)  
<sup>14</sup> ITA, ss 24(3)(c) and 28  
<sup>15</sup> ITA, s 24(2)  
<sup>16</sup> ITA, s 4(a)