IT 2550 - Income tax: assessability of profits made on the disposal of depreciated plant

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TAXATION RULING NO. IT 2550

INCOME TAX : ASSESSABILITY OF PROFITS MADE ON THE DISPOSAL OF DEPRECIATED PLANT

F.O.I. EMBARGO: May be released

REF N.O. REF: 87/2891-7 DATE OF EFFECT: Immediate

B.O. REF: DATE ORIG. MEMO ISSUED:

F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1011439	ASSESSABLE INCOME	25(1)
	DEPRECIATION	59(2)

PREAMBLE In two recent cases before the Full Federal Court of Australia a question has arisen concerning the proper tax treatment of "profits" derived from the sale of depreciated property. The "profits" in these cases represented the amount by which consideration received in respect of the disposal of depreciated plant exceeded the cost price of the plant.

2. In one case Memorex Pty Ltd v FC of T 87 ATC 5034; 19 ATR 553, the Court held that these profits constituted assessable income according to ordinary concepts whereas in another case, FC of T v Cyclone Scaffolding Pty Ltd 87 ATC 5083; 19 ATR 674, the Court found the profits to be capital in nature.

3. This ruling is issued in order to clarify policy in light of these two decisions.

FACTS 4. The Memorex case came to the Full Federal Court as the taxpayer's appeal from the decision of the Administrative Appeals Tribunal (Purvis J. Presidential Member) reported as Case U98, 87 ATC 589; AAT Case 65 18 ATR 3457. The taxpayer's business was that of a supplier of computer equipment. It bought the equipment from its American parent company and then either sold or leased the equipment to its customers. The taxpayer treated the equipment as plant and claimed a deduction in respect of depreciation.

5. In respect of the leased equipment, when the lease expired, the taxpayer would take back the equipment which would then either be re-leased to another customer, scrapped, or sold. From time to time equipment on lease to a customer would be sold to the customer on the customer's request. In one instance goods which were on lease to a customer were sold to a finance company to provide liquid funds for the taxpayer.

6. In accounting for the sales of leased equipment the taxpayer drew no distinction between these sales and other sales. The invoice issued to the lessee purchaser bore little difference to that of a normal sales invoice. In due course appropriate entries were made transferring the equipment from the "equipment

on lease account."

7. In the relevant tax returns for the income years in dispute the taxpayer returned as assessable income the amount of "balancing charge" calculated in accordance with section 59(2) of the Income Tax Assessment Act ("ITAA"). Any amount of consideration received in respect of the sale of the leased equipment in excess of the balancing charge was considered by the taxpayer to be a receipt of capital. This was not accepted. Instead the amounts of excess consideration were included in the taxpayers assessable income under section 25(1) of the ITAA.

8. The Cyclone Scaffolding case came to the Full Federal Court as the Commissioner's appeal from a decision of the Supreme Court of New South Wales (David Hunt J.) reported as Cyclone Scaffolding Pty Ltd v FC of T 87 ATC 4021; 18 ATR 148.

9. In this case the taxpayer owned scaffolding equipment. The major part of its business related to the hiring out of the scaffolding although it did on occasions sell scaffolding to customers who wished to purchase it. In the case of such sales the taxpayer would usually make a special purchase of equipment, although it did at times use equipment from the hiring pool. In the main, however, the taxpayer's major source of income was from hiring.

10. Where a hirer of scaffolding equipment lost or irreparably damaged the equipment, the hire contract provided that the hirer was liable to pay the taxpayer the cost of replacing the equipment at its current list price i.e., there was a "deemed" sale to the hirer.

11. Because of the nature of the scaffolding equipment it was impracticable for the taxpayer to trace every piece. Accordingly it adopted a number of arbitrary accounting procedures

12. First it treated all purchases during an income year as a purchase of trading stock, so that all profits on the sales of that equipment in that year were returned as assessable income and no depreciation in respect of that equipment was claimed. Secondly, at the end of the year all surviving trading stock was capitalised, described as plant and thereafter depreciated. Because all items were kept in a general pool, the taxpayer used a notional "last-in, first-out" system for determining which items were the subject of sales or deemed sales.

13. In the year in dispute, by reason of the "deemed" sales, total sales exceeded the amount of purchases. The profit from these excess sales related to the "deemed' sales of depreciated equipment. In respect of that profit the taxpayer accounted for it, for taxation purposes, in exactly the same manner as did Memorex Pty Ltd i.e., it returned the amount of balancing charge as assessable income as provided in section 59(2) of the ITAA and treated the excess as a capital receipt.

14. This method of accounting had been accepted for many years having regard to the 1955 decision in Case F63 6 TBRD (N.S.) 370. However, in the years in dispute the "deemed" sales had risen to such an extent that the profit arising from them was to be considered as arising from an ordinary and integral part of the taxpayer's business.

15. As in the case of Memorex Pty Ltd, the excess profit to Cyclone Scaffolding Pty Ltd was assessed as income according to ordinary concepts.

DECISIONS OF THE COURT

16. The Court in Memorex (Davies, Einfeld and Pincus JJ) dismissed the taxpayer's appeal holding that there was no basis for disturbing the Tribunal's decision that the profits were assessable income to the taxpayer by virtue of section 25(1).

17. The Tribunal had found that even where equipment had been leased to a customer, it was always within the contemplation of Memorex Pty Ltd that the equipment could be sold. It said that the taxpayer always intended and expected to profit by the realisation by lease or sale of its interest in the equipment. The Tribunal said the sales of the leased equipment were directly relevant to the profit-making activities of the taxpayer and an integral part of the taxpayer's business of dealing in computer equipment.

18. The Court rejected the taxpayer's submission that sections 54-62 of the ITAA provide a complete code for the taxation of goods which are at some time depreciable. It said that these sections do not purport or intend to deal with the assessability of profits which represent the difference between the cost price of the goods and their sale price. In particular it said these actions do not preclude that profit from being brought to account as income under section 25(1) of the ITAA if it is otherwise proper to do so.

19. Pincus J. addressed the issue of whether or not a net profit, such as was the case here, could be included as "gross income" under section 25(1). After examining the comments of Gibbs CJ in FC of T v Whitfords Beach Pty Ltd (1982) 150 CLR at P. 360 and Mason J in Commercial and General Acceptance Ltd v FC of T (1977) 137 CLR 373 at pp. 382-383 he held that a net profit could be included as assessable income under section 25(1) in the circumstances.

20. In the Cyclone Scaffolding case the Court, (Bowen CJ and Beaumont J., Wilcox J. dissenting) dismissed the Commissioner's appeal, holding that the taxpayer had adopted a method of accounting designed to give a substantially correct reflex of its true income. It said that if, as was the case here, the Commissioner accepted that treatment it would not be open to him to then ignore it by removing the case from its context and claiming that certain transactions had generated income as ordinarily understood.

21. The majority went on to say that if it were possible to isolate those transactions from their context within the general framework of the taxpayer's treatment of its overall activities, there would be much to be said for the Commissioner's decision to assess the profit as income. The majority also found that the finding of David Hunt J. at first instance, that the taxpayer's substantial purpose in purchasing the equipment was to hire it out rather than to re-sell it, was open to him on the evidence adduced.

22. Wilcox J. in dissent took an entirely different approach to the question. He said that this case was not to be decided by the application of the correct reflex approach and addressed himself to the question of whether the particular profits in question constituted income. He ultimately found that they did constitute income and his reasoning in so finding closely followed that of Davies, Einfeld and Pincus JJ. in the Memorex case.

23. An application was made to the High Court for special leave to appeal from the decision of the Full Federal Court in favour of Cyclone Scaffolding. In refusing the application the High Court said that the case depended upon its own facts in relation to one income year. A finding by the Supreme Court that there was no power to amend six other years assessments had been accepted. The High Court intimated that the majority had applied the correct legal principle in deciding the case.

RULING

24. The two Federal Court decisions are not readily reconcilable. The better view seems to be that the question of whether profit on the sale of depreciated plant can constitute income according to ordinary concepts is to be first answered by reference to general principles regarding the treatment of profits arising from the sale of goods. Only after that does the question arise of whether the accounting method employed gives the "correct reflex".

25. It is clear from the High Court decisions in London Australia Investment Co. v. FC of T (1977) 138 CLR 355 that whether a profit from the sale of an investment constitutes assessable income will depend on whether the sale is merely a realization of the asset or whether the sale is something done in what is truly the carrying on, or carrying, out of business. That question is one fact to be decided in all the circumstances.

26. David Hunt J., in the first instance in the Cyclone Scaffolding case, specifically rejected the Commissioner's submission that in the circumstances the "deemed" sales formed a regular and systematic part of the taxpayer's business, and said that the taxpayer's business was to be properly characterized as one of hiring. The majority in the Full Federal Court agreed with this finding, but did not consider the question whether the profits from the "deemed" sales constituted income.

27. It is not conceded that a substantial or dominant purpose of deriving income by hiring equipment necessarily precludes a conclusion that profits on equipment sales are also income.

Even a gain made otherwise than in the ordinary course of business may constitute income; the business context itself can be a fact of telling significance: F.C.of T. v. The Myer Emporium Ltd (1987) 163 CLR 199, 87 ATC 4363, 18 ATR 693. In deciding whether a sale gives rise to assessable income, regard should be had to the contemplation or intention of the taxpayer at the time of acquisition, of how he expected to profit from the equipment and whether the sales are a regular and systematic incident of the taxpayer's profit-making activities.

28. In most cases, where leased equipment is purchased ostensibly for hire but is always available for sale and such sales are a regular and systematic part of the taxpayer's business profit in excess of the balancing charge will be assessable as income according to ordinary concepts under section 25(1) of the ITAA.

29. It follows, therefore, that where such sales do form part of the taxpayer's ordinary course of business such that the profit constitutes assessable income, it will not be open to a taxpayer to adopt a system of accounting for tax purposes which will regard that profit as capital, as for instance, Cyclone Scaffolding Pty Ltd did. The reason for this is that an accounting method which does not account for that profit as income could not be said to give a "substantially correct reflex of income" (per Dixon J. in Commissioner of Taxes (SA) v Executor Trustee and Agency Co. of South Australia Ltd (1938) 63 CLR 108 at P.154 "Carden's Case) and therefore would not be an appropriate method of accounting for the taxpayer's assessable income.

30. The capital gains and capital loss provisions contained in Part IIIA of the ITAA would usually apply on the disposal of an asset that is depreciable plant of a taxpayer. However, subsection 160ZA(4) operates to reduce a taxable capital gain in certain circumstances where, as a result of the disposal of the asset, an amount is assessable to the taxpayer under another provision of the ITAA. An amount taxable under subsection 25(1) on the basis that the sale of depreciable plant took place in the taxpayer's ordinary course of business would, by the operation of subsection 160ZA(4), reduce the taxable capital gain to zero so that, in effect, Part IIIA would not apply to the asset disposed of.

31. Where an amount is assessable under subsection 59(2) by way of a depreciation balancing charge, subsection 160ZA(4) will not reduce the taxable capital gain on the disposal of the depreciable asset by the amount so assessable. The application of Part IIIA on the disposal of a depreciable asset in circumstances where the disposal occurs outside the ordinary course of the taxpayer's business must therefore be considered. Broadly, where the consideration for the disposal exceeds the indexed cost base of the asset, the amount of the excess will be a taxable capital gain under Part IIIA.

32. It is essential to the calculation of the amount of capital gain that the date of acquisition and the date of disposal of

the equipment are able to be accurately identified. Accordingly, it will not be open to a taxpayer (at least for tax purposes) to adopt a method of accounting which is unable to identify the dates of acquisition and disposal in respect of each individual piece of equipment. In situations where it is impracticable to identify, and therefore to trace the commercial history, of each item of equipment, taxpayers should approach the Commissioner in order that an alternative compromise method of accounting can be agreed upon.

33. In summary, the decision of the Full Federal Court in FC of T v Cyclone Scaffolding Pty Ltd (supra) is seen as having limited application; as the High Court said in the special leave proceedings, to the particular facts in the particular income year. In general, where the sale of depreciated equipment forms part of the ordinary course of the taxpayer's business, the amount of profit (in excess of the balancing charge) should be included in assessable income under section 25(1).

COMMISSIONER OF TAXATION
17 August 1989