IT 2670 - Income tax: meaning of "trading stock on hand"

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This ruling contains references to repealed provisions, some of which may have been rewritten. The ruling still has effect. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten. The legislative references at the end of the ruling indicate the repealed provisions and, where applicable, the rewritten provisions.

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TAXATION RULING IT 2670

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I 1013070	**TRADING STOCK - IN TRANSIT - ON HAND**	**28 Part IVA**

OTHER RULINGS ON THIS TOPIC: IT 2207, IT 2325, IT 2472

TITLE: INCOME TAX: MEANING OF "TRADING STOCK ON HAND"

NOTE: . Income Tax Rulings do not have the force of law.

. Each decision made by the Australian Taxation Office is made on the merits of each individual case having regard to any relevant Ruling.

PREAMBLE

Section 28 of the Income Tax Assessment Act 1936 (the "Act") requires that the value of all "trading stock on hand" at the beginning and at the end of a year of income is taken into account in ascertaining the taxable income of a taxpayer carrying on a business.

2. In All States Frozen Foods Pty Ltd v. F.C. of T. (1990) 21 FCR 457 (90 ATC 4175; (1990) 20 ATR 1874), the Full Federal Court of Australia (Bowen C.J., Lockhart and Gummow JJ.) upheld the decision of Davies J. in F.C. of T. v. All States Frozen Foods Pty Ltd (1989) 88 ALR 575 (89 ATC 5135; (1989) 20 ATR 1454) that the goods en route from overseas suppliers were in certain circumstances trading stock on hand of the taxpayer.

RULING

3. Goods are "trading stock on hand" for purposes of section 28 of the Act, notwithstanding that they have not been physically delivered to the taxpayer's business premises or outlet provided the taxpayer is in a position to dispose of the goods.

4. The importance of dispositive power over all other tests (such as, for example, property or possession) is demonstrated by the decision of the High Court of Australia in Farnsworth v. F.C. of T. (1949) 78 CLR 504. A fruit grower had delivered dried fruit to a packing house where it had been mixed with other growers' fruit. Was it still the grower's stock on hand? The Court unanimously held that it was not her stock on hand but did so for three different reasons. In the leading judgment Dixon J. (with whom McTiernan J. agreed) at p.518 relied on the fact that the taxpayer had no dispositive power over the fruit and no power to direct or control the disposal of it by the packing house. Rich J. at p.515 also noted that the grower had lost all control and power of disposition of the fruit.

5. The view that dispositive power is the appropriate test is supported by the decision in All States Frozen Foods. When discussing the change in wording between the 1922 Act and the 1936 Act, the Court said (FCR at p.459; ATC at p.4177; ATR at p.1876):

> "We do not consider that changing the expression from trading stock 'not disposed of' to trading stock 'on hand' was intended to alter the law. It was a conversion to the language of commerce."

PROPERTY

6. However, in most cases a taxpayer having property in the stock will entail a power of disposition over it so that it will be the taxpayer's trading stock on hand even though the taxpayer may not have physical possession of it. In the All States Frozen Foods case the Court found that the taxpayer was the owner of the goods even though it did not have physical possession because they were on board vessels on the high seas at the time. In a passage of his judgment adopted by the Full Court, Davies J. explained that accounting and trading concepts required the goods to be recorded as stock (ALR at p.580; ATC at p.5140; ATR at p.1458):

> "Having accepted the bills of lading it was the owner of the goods, they were at its risk, it was entitled to possession of them and it had control, dispositive power over them. Why then were not the goods recorded as stock...." (emphasis added)

and continued at (ALR) p.581 (ATC at p.5141; ATR at p.1459):

> "The words 'trading stock on hand' in s 28 thus refer to the trading stock held by the taxpayer at the specified time. Because the trading stock provisions are based on well known concepts of trade and accountancy, those concepts of what stock a trader holds and thus what should be

> brought to account in a calculation of the profits or income of the year provide a guide as to the stock 'on hand' at the relevant date. In the present case, that stock included the goods in respect of which bills of lading were held."

7. Similar views can be found in the House of Lords decision in Benjamin Smith and Son v. Commissioners of Inland Revenue (1928) 139 LT 97 (although in relation to a different statutory context). At p.99 Lord Sumner said:

> "It can hardly be doubted that shippers, whose trading stock included grain, which they had sold and had to deliver, could claim to treat it as part of their stock in hand, when the property was still vested in them and the grain was still at their disposition pending the actual taking up of the shipping documents. If so, the same grain could not at the same time be also the trading stock in hand of the appellants, to whom it did not yet belong, and to whom the right of present disposition had not yet passed, whatever the future intentions of the parties might be in the matter...." (emphasis added)

8. The passing of property in goods is determined by the intention of the parties but, in the case of unascertained goods, it cannot be before ascertainment. What was intended will be determined by reference to the contract terms (including implied terms), the conduct of the parties (including their practice over a course of dealing) and the circumstances of the case (including commercial practice in that industry and assumption of risk). The rules governing the intention of the parties (unless a different intention appears) are laid out in the various State Sale of Goods Acts.

9. Subject to that intention, it is generally taken that, where the contract requires the seller to send goods to the buyer, delivery of the goods to the selected carrier will be treated as delivery to the buyer and property will pass to the buyer at that point.

10. In the case of shipment of goods by sea, there is usually an intention that property will not pass when the goods are delivered to the carrier. Instead, delivery and transfer of property to the buyer are usually effected by delivery of the "bill of lading" (a memorandum signed by the ship's master or shipowner's agent acknowledging receipt of the goods for carriage). Although not always the case (e.g., when the dealing is between associated companies - see The Albazero [1977] A.C. 774 at pp.796-799, 840), this is the usual position with "Cost, Insurance and Freight" ("c.i.f.") and "Cost and Freight" ("c. and f.") contracts.

11. However, it is not the usual position with "Free into Store" ("f.i.s.") contracts under which the parties generally intend that delivery occurs (and property passes) when the goods arrive in the buyer's store (Gold Coast Bakeries Pty Ltd v. J.G. Gregorson & Co Pty Ltd (1974) 2 QL 312 at p.319; Sutton, K.C.T., Sales and Consumer Law in Australia and New Zealand, 3rd ed., Law Book Company, 1983 at p.366). It is also not usually the case with "Free on Board" ("f.o.b.") contracts in which the parties generally intend that property will pass when the goods are delivered over the ship's rail, unless the seller deals with the bill of lading in a manner which shows that he has reserved a right of disposal (James v. Commonwealth (1939) 62 CLR 339 at p.385).

NO PROPERTY

12. Conversely, a taxpayer who does not have property in the stock will not usually treat it as stock on hand because the taxpayer will not be able to dispose of it. However, because the test is not property but dispositive power, this need not always be so. In F.C. of T. v. Suttons Motors (Chullora) Wholesale Pty Ltd (1984-85) 157 CLR 277 (85 ATC 4398; (1985) 16 ATR 567), the High Court upheld the decision of the Federal Court that the taxpayer was entitled to a trading stock valuation adjustment under subsection 82D(1). This required the conclusion that cars, being the property of General Motors Acceptance Corporation, were the trading stock on hand of Suttons Motors. At (CLR p.283; ATC at p.4401; ATR at pp.571-572), the majority judges of the High Court said:

> "The relevant vehicles were, at the commencement of the tax year, plainly in the possession and at the risk of the Suttons Group. They were held by the Group for the purpose, and only for the purpose, of being offered for sale in the ordinary course of the composite business which that Group, looked at as a whole, carried on. They represented the stock which the Group held to offer for sale and to sell in the course of that overall business and which it had become entitled to, and commercially though not legally obliged to, purchase from G.M.H. at G.M.H.'s wholesale price at the time it took delivery. If the Group's overall business from the original acquisition of possession of vehicles under the floor plan arrangement to the ultimate retail sale of them to the public be viewed as a composite whole, it appears to us that the relevant motor vehicles were, at the commencement of the tax year, the trading stock on hand in relation to that business within the traditional and central meaning of the term 'trading stock'."

13. Where a taxpayer does not own the stock, the Commissioner will treat the taxpayer as having sufficient dispositive power for the stock to be trading stock on hand where the circumstances explained by the High Court in the above passage are, in substance, the same. Satisfaction of the tests set out by the High Court will effectively deny the owner any power of disposition in such circumstances and, in any event, goods can be accounted for as the trading stock of only one taxpayer at a time.

AGENTS

14. Where a taxpayer gives an agent power to dispose of the stock, the stock will remain trading stock on hand of the taxpayer (even if the agent has physical possession) because the taxpayer has a power to dispose of the stock; it is merely executed through the agent (see Farnsworth's case at p.518).

15. In many cases dispositive power will vest in a taxpayer by delivery of the goods to an agent of the taxpayer. One common example is the delivery of a bill of lading to a bank which has promised to pay on behalf of the buyer. The bank is the buyer's agent so that delivery to it is treated as delivery to the buyer.

16. The agent, of course, has no power to dispose of the stock on his own behalf and so could not account for it as his trading stock on hand. This is so even if the agent is independently in the business of trading in such goods.

POSSESSION

17. A taxpayer will be considered to have a power of disposition over the trading stock, even though not able to give immediate possession, unless it can be shown that the power of disposition has been transferred to another taxpayer, as it had in Suttons Motors. For example, if the stock is in an offsite warehouse or in a bond store it will be trading stock on hand. Where the stock consists of raw materials which will be converted into another condition before sale, it will still be trading stock on hand (F.C. of T. v. St. Huberts Island Pty Ltd (1978) 138 CLR 210 at pp.226-229, 235, 241-242; 78 ATC 4104 at pp.4112-4113, 4117, 4120; (1978) 8 ATR 452 at pp.461-463, 467, 471). Similarly, goods in transit (as in the All States Frozen Foods case) can be trading stock on hand. As a final example, stock can be trading stock on hand even though steps outside the taxpayer's control need to be performed before title and possession can be transferred (e.g. the approval of a security holder or a governmental body, or the discharge of a mortgage). Each of these is a case of stock which can be, but is

not yet, disposed of, so that a power of disposition does reside with the taxpayer. As the Full Federal Court observed in the All States Frozen Foods case (1990) 21 FCR at p.459 (90 ATC at p.4177; 20 ATR at p.1876), changing "trading stock not disposed of" (the 1922 Act) to "trading stock on hand" (the 1936 Act) was not intended to alter the law.

TAX AVOIDANCE

18. Where parties to certain international arrangements are associated with each other, the associated enterprises article in the relevant double tax agreement (e.g. Article 9 of the USA agreement and Article 5 of the Japanese agreement) can operate to tax the Australian party on those profits that would have accrued if the arrangements had been at arm's length. For example, the shipment terms might defer the point at which goods become stock on hand. In such cases, the article may tax the parties as if the terms of shipment were those that would have been entered into had the dealing been at arms length.

19. Where arrangements are contrived to prevent trading stock being on hand at the end of a year of income, consideration should also be given to the application of Part IVA.

COMMISSIONER OF TAXATION
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