TR 95/7 - Income tax: lay-by sales

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Taxation Ruling
Income tax: lay-by sales

other Rulings on this topic

IT 2670

contents **para**

What this Ruling is about **1**
Class of person/arrangement 1
Ruling **4**
When income is derived under a lay-by sale 4
Whether goods held by a seller under a lay-by sale are trading stock on hand 8
Income tax consequences for a seller if a buyer terminates a lay-by sale agreement or if it is otherwise terminated 9
Date of effect **10**
Explanations **12**
General background and State legislation 12
When income is derived 17
Whether goods held by a seller under a lay-by sale are trading stock on hand 36
Income tax consequences for a seller if a buyer terminates a lay-by sale agreement or if it is otherwise terminated 39
Examples **42**

This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the ***Taxation Administration Act 1953****, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

Class of person/arrangement

1. This Ruling considers:

(a) when income is 'derived' for the purposes of subsection 25(1) of the *Income Tax Assessment Act 1936* (ITAA) by a seller of goods under a lay-by sale agreement; and

(b) whether goods held by a seller at the end of a year of income which are subject to a lay-by sale agreement are 'trading stock on hand' of the seller at the end of the year of income for the purposes of section 28 of the ITAA; and

(c) the income tax consequences for a seller if a buyer under a lay-by sale agreement terminates the lay-by sale or if it is otherwise terminated.

2. The Ruling deals only with those cases where:

(a) the goods sold by lay-by are trading stock of a seller; and

(b) the trading income of the seller is assessable on an accruals, rather than a cash, basis.

3. In this Ruling, the term 'lay-by sale agreement' refers to an agreement (not being a hire-purchase agreement) under which goods are sold, or are agreed to be sold, on terms that the goods will not be delivered to the buyer until the purchase price is paid in full. The purchase price is commonly payable by way of an initial deposit and the balance either by instalments (whether the number of instalments or the amount of any of the instalments is fixed by agreement or is left to the option of the buyer) or at the expiration of a fixed or ascertainable period with an option for the buyer to make payments in respect of the purchase price during that period. The initial deposit is,

in some cases, a non-refundable deposit. Specific goods are identified as subject to a particular lay-by sale agreement, are physically separated from the seller's other trading stock, and are stored by the seller pending delivery to the buyer on payment in full of the sale price.

Ruling

(a) When income is derived under a lay-by sale

When does a sale occur and a debt is created?

4. With one exception, income from the sale of goods by lay-by which is assessable on an accruals basis is derived by a seller for the purposes of subsection 25(1) of the ITAA when a sale takes place and a debt is created. We consider that this is when the buyer pays the final instalment of the purchase price and the goods are delivered to the buyer.

5. The exception is any initial deposit which, by the terms or conditions of the lay-by sale, is a non-refundable deposit that a buyer is required to pay to a seller. Ordinarily, it is required to be paid on or shortly after it becomes due, i.e., before the goods are delivered. A non-refundable deposit is derived by, and is assessable to, a seller when it is due to be paid by the buyer.

When are amounts received under a lay-by sale earned?

6. With one exception, amounts received (e.g., initial deposit and instalments) by the seller from the buyer while goods are held by the seller under a lay-by sale are not earned by the seller, and therefore are not derived for the purposes of subsection 25(1) of the ITAA, until the buyer pays the final instalment of the purchase price and the goods are delivered to the buyer.

7. The exception is any initial deposit which, by the terms or conditions of the lay-by sale, is a non-refundable deposit that a buyer is required to pay to a seller. A non-refundable deposit is earned and is derived by a seller when it is due to be paid by the buyer.

(b) Whether goods held by a seller under a lay-by sale are trading stock on hand

8. Goods in the possession of a seller at the end of a year of income which are subject to a lay-by sale agreement are 'trading stock on hand'

of the seller for the purposes of section 28 of the ITAA at the end of the year of income.

(c) Income tax consequences for a seller if a buyer terminates a lay-by sale agreement or if it is otherwise terminated

9. The income tax consequences for a seller if a lay-by sale is ended early are as follows:

(a) If a lay-by sale agreement is terminated prematurely, any part of the sale price which has been received and is refundable to the buyer or which will not be received is not a loss or outgoing incurred by the seller which is deductible under subsection 51(1) of the ITAA. When an amount received by the seller from the buyer is refunded (the amount not having been included in assessable income of the seller because they have not been derived), there are no income tax consequences for the seller.

(b) Any amount which is forfeited to a seller by a buyer, whether on a termination of a lay-by sale by the buyer or on a termination by breach of the agreement, becomes an actual receipt earned by the seller when the lay-by sale is terminated. It is derived at that time by the seller as income.

(c) Similarly, any selling, handling or storage costs which the seller is entitled to retain from an amount refunded to a buyer, becomes an actual receipt earned by the seller when the lay-by sale is terminated. It is derived at that time by the seller as income.

[This does not apply, of course, to any non-refundable service fee or other non-refundable fee or charge that the parties intend the seller to retain. This fee or charge is derived by the seller when the lay-by sale is entered into by the parties.]

(d) If a lay-by sale is terminated, a seller having received a non-refundable initial deposit from a buyer, and the seller decides, in the circumstances of a particular case, to refund the deposit (in whole or in part), the seller is entitled to an allowable deduction under subsection 51(1) of the ITAA to the extent of the amount refunded.

Date of effect

10. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

11. If a lay-by sale has been accounted for in a return of income in a year before the final instalment is paid and the goods are delivered, the appropriate remedy for a taxpayer to correct this situation is by way of amendment of the relevant previous year's assessment. Assessments may be amended in this respect within the time limits authorised under the ITAA: *Country Magazine Pty Ltd v. FC of T* (1968) 117 CLR 162 at 166; 15 ATD 86 at 89.

Explanations

General background and State legislation

Industry practice

12. The conclusions reached in this Ruling are based on the following industry practice:

(a) Retail traders intend property in goods sold under lay-by to pass when the customer pays the full price for the goods and takes delivery. Customers also presumably intend property to pass then because they know that they cannot take possession of the goods unless and until the balance of the purchase price is paid.

(b) In the event of loss or damage to goods while they are held by a retail trader under lay-by, it is the retail trader who bears the loss. Retail traders understandably therefore insure the goods.

(c) The price of goods sold by lay-by is not due (in the sense of owing) until delivery; before delivery a customer may opt not to proceed with the purchase. Because the customer can choose not to pay the balance of any outstanding instalments, a retail trader does not have a right to sue for any part of the purchase price as a debt before the goods are delivered.

(d) Retail traders often impose time limits on completion of lay-by sales, failing which deposits are usually refunded less handling charges. This varies from retailer to retailer

and according to different State legislation, e.g., *Fair Trading Act 1987* (NSW).

(e) Retail traders do not consider that they lose dispositive power over goods when they commence to be held under lay-by. The retailer may dispose of the goods if the customer defaults on the contract after taking a number of recommended steps (including writing to the customer informing him or her of any intended actions) and a reasonable time has elapsed. However, retailers tend not to dispose of the goods during the contract period.

(f) No interest or charge is imposed by the retailer for holding goods under lay-by. However, some retailers may impose a nominal non-refundable service fee and others impose a selling cost fee. This may be governed by State legislation.

(g) According to the Retailers' Council of Australia, if a customer decides to terminate a lay-by after making some payments to a retail trader, the retail trader does not, in practice, retain any of the amounts received before payment of the full purchase price (but see subparagraph (h) regarding non-refundable deposits).

(h) According to the Retail Traders' Association of Victoria (RTAV), at least in Victoria where lay-by sale agreements are not covered by specific legislation, it is open to retail traders to require the payment by a buyer of a non-refundable initial deposit. As its name implies, these deposits are not ordinarily refunded if a lay-by sale is terminated. On occasions, however, a retail trader might refund such a deposit based on the particular circumstances of an individual case.

State legislation

13. In New South Wales (NSW) and the Australian Capital Territory (ACT) there is legislation specifically dealing with lay-by sales (*Fair Trading Lay-by Amendment Act 1993* (FTLA Act NSW) and *Lay-by Sales Agreement Act 1963* (ACT)).

14. However, the FTLA Act (NSW) does not affect the operation of the *Sale of Goods Act* with respect to a lay-by in that State. In the ACT, the *Sale of Goods Act 1954* (ACT) applies, subject to the *Lay-by Sales Agreement Act 1963* (ACT).

15. In the other States and the Northern Territory, lay-by sales are governed by the provisions of their *Sale of Goods Act* or, in the case of Victoria, by the *Goods Act 1958* (Vic).

16. A lay-by sale is a contract for the sale of goods involving the postponement of payment of parts of the purchase price and delivery of the goods. Lay-by sales are therefore sales of goods under the various State and Territory Sales of Goods legislation.

(a) When income is derived

When does a sale occur and a debt is created?

17. Income from the sale of trading stock is derived for the purposes of subsection 25(1) of the ITAA when the stock is sold and a debt is created. It need not be payable in the year of income (*J Rowe and Son Pty Ltd v. FC of T* (1971) 124 CLR 421; 71 ATC 4157; (1971) 2 ATR 497 (*Rowe's* case)).

18. In *Rowe's* case, trading stock was sold on terms that payment of the sale price was to be made by instalments over a period of up to five years. The High Court of Australia held that the sale price was wholly derived in the year of sale, rather than as and when the instalments were due and payable. In delivering the leading judgment in the case, Menzies J stated (at CLR 448, ATC 4158, ATR 499):

> 'In a system of annual accounting, ordinary business considerations would indicate that what becomes owing to a company for trading stock sold during a year should, in some way, be brought into account to balance the reduction of trading stock which the transaction effects. Any other method of accounting would lead to a misrepresentation of the trader's financial position.'

19. As the Full Federal Court of Australia pointed out in *Gasparin v. FC of T* 94 ATC 4280; (1994) 28 ATR 130 (per von Doussa J at 4285, with whose judgment Jenkinson and Spender JJ agreed), prominence was given by the High Court in *Carden's* case (*The Commissioner of Taxes (South Australia) v. The Executor Trustee and Agency Company of South Australia Ltd* (1938) 63 CLR 108; 5 ATD 98) and in *Rowe's* case to the importance of there being a debt in conjunction with a sale of trading stock before income is derived.

20. In order to determine when:

(a) a sale occurs; and

(b) a debt is created, i.e., a debt to the seller is due by the buyer (even though the debt may not be payable forthwith)

in respect of goods sold by lay-by, it is necessary to refer to the various State Sale of Goods Acts, the legislation specifically dealing with lay-by sales in NSW and the ACT, and to the terms of the contract, the conduct of the parties and the circumstances of the case.

21. For a sale of goods to occur, the general property in the goods must, by the transaction, be transferred by the seller to the buyer for a money consideration called the price.

22. The property in goods passes at such time as the parties intend. This intention is to be ascertained by reference to the terms of the contract, the conduct of the parties and the circumstances of the case.

23. The sale proceeds on a sale of goods mature into a recoverable debt, i.e., a debt is created when the sale proceeds are due (in the sense of owing), even though they may only become payable at some future date: see, for example, *Gasparin's* case and *Ladenburg & Co v. Goodwin Ferreira & Co Ltd (in liq) and Garnett* [1912] 3 KB 275.

24. With one exception (see paragraph 31), sale proceeds are therefore derived, for the purposes of subsection 25(1) of the ITAA, when the price is due according to the terms of the particular contract of sale.

25. When the price is so due may occur before the seller is entitled to sue for the price. When the price is so due need not necessarily bear any relationship to the time property in the goods is transferred to the buyer or to the time the goods are delivered to the buyer. If no time is specified in the contract as to when the price is due, the previous course of dealing between the parties, in appropriate cases, may establish when it is due. If when the price is due cannot be so implied, the sale proceeds are prima facie due when the seller informs the buyer that the seller is ready and willing to deliver possession of the goods. This is so because, by virtue of the Sale of Goods legislation (section 31 of the *Sale of Goods Act 1923* (NSW); section 35 of the *Goods Act 1958* (Vic); section 30 of the *Sale of Goods Act 1896* (Qld); section 28 of the *Sale of Goods Act 1895* (SA); section 28 of the *Sale of Goods Act 1895* (WA); section 33 of the *Sale of Goods Act 1896* (Tas; section 32 of the *Sale of Goods Act 1954* (ACT); and section 31 of the *Sale of Goods Act* (NT)), delivery of the goods and payment of the price are, unless otherwise agreed, concurrent conditions: *Benjamin's Sale of Goods*, 4th ed, Sweet & Maxwell London 1992 at paragraphs 8-004, 9-020 and 9-050.

26. We consider that, subject to the effect of specific lay-by sales State or Territory legislation, the same rules (i.e., those considered in paragraphs 18 to 22 of this Ruling) ordinarily govern sales of goods by lay-by.

27. Having regard to the nature of a lay-by sale (in which a buyer can, in effect, decide when to make payments in respect of the purchase price during the period of the lay-by sale agreement), the usual terms of a lay-by sale agreement, the conduct of the parties, the commercial and business practice in relation to lay-by sales, and the retaining of possession of the goods and assumption of risk by the seller, there are, in our view, compelling inferences that:

(a) the parties to a lay-by sale agreement intend that property in the goods passes, and therefore, a lay-by sale only occurs; and

(b) a debt to the seller is due by the buyer

when the buyer pays the final instalment of the purchase price and the goods are delivered to the buyer. It is then, in our view, that a sale takes place, the seller has transferred to the buyer the significant risks and rewards of ownership, and a debt to the seller is due by the buyer.

28. This conclusion accords with the long standing view we have taken for sales tax purposes, namely, that lay-by sales are not effected until the final payment has been made and delivery is made to the customer.

29. We consider that the specific lay-by sales legislation in NSW and the ACT does not require a different conclusion. Even in the ACT, where property in goods under a lay-by sale passes when the lay-by sale agreement is made (subsection 13(1), *Lay-by Sales Agreement Act 1963* (ACT)), it is clear from a reading of that Act as a whole that a sale of the goods is only completed when the buyer pays the final instalment of the purchase price and the goods are delivered to the buyer.

30. Income from a sale of goods by lay-by is therefore derived by a seller for the purposes of subsection 25(1) of the ITAA when the buyer pays the final instalment of the purchase price and the goods are delivered to the buyer.

31. There is an exception to the general rule that income from a lay-by sale is derived on the payment of the final instalment and delivery of the goods. If it is a term or condition of a lay-by sale that the buyer must pay a non-refundable deposit, this deposit is derived by the seller when it matures into a debt recoverable by the seller. A non-refundable deposit matures into a recoverable debt owed to the seller when, according to the terms or conditions of the lay-by sale, the deposit is due to be paid by the buyer to the seller. This ordinarily occurs on or shortly before its actual payment.

When are amounts received under a lay-by sale earned?

32. A seller receives amounts under a lay-by sale (whether a deposit, an instalment or a payment made by the buyer in respect of the purchase price) subject to a contingency that, should the buyer determine the lay-by sale prematurely, the whole or some part of the amounts received may have, in effect, to be paid back to the buyer. The possibility, in practical terms, of having to pay these amounts back is an inherent characteristic of a lay-by sale, and therefore, of the receipts themselves. As a matter of good business sense, it is prudent for a seller to treat the amounts received in advance of the goods being sold under a lay-by sale agreement as being not yet earned: *Arthur Murray (NSW) Pty Ltd v. FC of T* (1965) 114 CLR 314; 14 ATD 98.

33. Amounts received by the seller from the buyer while goods are held by the seller under a lay-by sale are not earned by the seller, in our view, until the sale is completed, i.e., when the buyer pays the final instalment of the purchase price and the goods are delivered to the buyer.

34. The amounts received by the seller in these circumstances are therefore not derived by the seller as income, for the purposes of subsection 25(1) of the ITAA, until the buyer pays the final instalment of the purchase price and the goods are delivered to the buyer.

35. Again, there is an exception to the general rule that sale proceeds under a lay-by sale are not earned by a seller until the sale is completed. If it is a term or condition of a lay-by sale that the buyer must pay a non-refundable initial deposit, this deposit is earned by the seller when the deposit is due under that term or condition.

(b) Whether goods held by a seller under a lay-by sale are trading stock on hand

36. Our views on the meaning of the expression 'trading stock on hand' are set out in Taxation Ruling IT 2670. In short, goods are 'trading stock on hand' if the taxpayer is in a position to dispose of the goods (*All States Frozen Foods Pty Ltd v. FC of T* 90 ATC 4175; (1990) 20 ATR 1874). Accordingly, a taxpayer who has property in trading stock usually treats it as stock on hand because the taxpayer is able to dispose of it.

37. In the case of a lay-by sale agreement, the goods are not disposed of for the purposes of the ITAA until there is both a loss of 'dispositive power' over the goods and a debt is due by the buyer to the seller.

38. In our view:

(a) the parties to a lay-by sale agreement intend that property in the goods passes, and therefore, a lay-by sale only occurs; and

(b) the debt to the seller is due by the buyer

when the buyer pays the final instalment of the purchase price and the goods are delivered to the buyer. Until then, the seller has not lost 'dispositive power' over the goods and they constitute 'trading stock on hand' at the end of a year of income.

(c) Income tax consequences for a seller if a buyer terminates a lay-by sale agreement or if it is otherwise terminated

39. Generally, a lay-by sale agreement can be terminated by notice given by either party. On such a termination, the buyer is usually refunded any amounts already paid, less any costs incurred by the seller in connection with the sale. Or the agreement may be terminated by a party breaching its terms.

40. In either case, the termination may have consequences for the seller's entitlement to retain any amounts received or to receive any amounts outstanding. The seller will not have treated the amounts received in respect of the purchase price of the goods as assessable income.

41. The income tax consequences for the seller if a lay-by sale is terminated are as follows:

(a) If the seller refunds to the buyer an amount already received, or if the buyer decides to pay no further amount, the amount refunded or the amount which will not be received is not a loss or outgoing incurred by the seller which is deductible under subsection 51(1) of the ITAA. When the amount received by the seller from the buyer is refunded (the amount not having been included in assessable income of the seller because they have not been derived), there are no income tax consequences for the seller. We consider that the seller has not incurred any loss or outgoing for the purposes of subsection 51(1).

(b) Any amount which is forfeited to a seller by a buyer, whether on a termination of a lay-by sale by the buyer or on a termination by breach of the agreement, becomes an actual receipt earned by the seller when the lay-by sale is terminated. It is derived at that time by the seller as income.

(c) Similarly, any selling, handling or storage costs which the seller is entitled to retain from an amount refunded to a

buyer, become an actual receipt earned by the seller when the lay-by sale is terminated. It is derived at that time by the seller as income. Any non-refundable service fee or other non-refundable fee or charge that the parties to a lay-by sale intend the seller to retain, on the other hand, becomes due (in the sense of owing) and is therefore derived by the seller when the lay-by sale is entered into by the parties.

(d) A seller may receive a non-refundable initial deposit from a buyer (refer to paragraphs 3, 5, 7, 31, 35 and subparagraphs 9(d) and 12(h) of this Ruling) but the lay-by sale might be terminated. If this occurs and the seller decides, in the circumstances of a particular case, to refund the deposit (in whole or in part), the seller incurs a loss or outgoing for the purposes of subsection 51(1) of the ITAA to the extent of the amount refunded. A deduction is therefore allowable for the amount of the deposit that is refunded.

Examples

Example 1

42. On 20 June 1994, Peta entered into a lay-by sale agreement with Shopmart Stores Ltd to purchase goods priced at $300. Peta is required to pay $30 deposit and the balance by 2 September 1994. The goods are removed from display, labelled with a reference to the lay-by sale agreement, and set aside in an area of Shopmart's store separate from its other stock.

43. The full sale price of $300 is derived by Shopmart as income under subsection 25(1) in the year of income ended 30 June 1995. The goods held by Shopmart which are subject to the lay-by sale agreement are trading stock on hand under section 28 for the year of income ended 30 June 1994.

Example 2

44. In Example 1, let us assume Peta decided that she no longer wanted the goods, and she notified Shopmart on 18 July 1994 that she wished to terminate the agreement. At that stage, Peta had paid instalments totalling $150, in addition to the $30 deposit. Shopmart refunds Peta $155, being entitled to retain $25 for storage and other selling costs.

45. As a result of the agreement being terminated, Shopmart has refunded $155 ($30 deposit plus $150 instalments less $25 storage and selling costs) it had received and it will not receive the balance of $120 of the full purchase price. It is not entitled to a deduction under subsection 51(1) of the ITAA for a loss or outgoing of either the amount of $155 or $120 in either the year of income ended 30 June 1994 or 30 June 1995. Shopmart derives the amount of $25 that it retained as income under subsection 25(1) in the year of income ended 30 June 1995.

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- All States Frozen Foods Pty Ltd v. FC of T 90 ATC 4175; (1990) 20 ATR 1874
- Arthur Murray (NSW) Pty Ltd v. FC of T (1965) 114 CLR 314; 14 ATD 98
- Country Magazine Pty Ltd v. FC of T (1968) 117 CLR 162; 15 ATD 86;
- The Commissioner of Taxes (South Australia) v. The Executor Trustee and Agency Company of South Australia Ltd (1938) 63 CLR 108; 5 ATD 98
- Gasparin v. FC of T 94 ATC 4280; (1994) 28 ATR 130
- Ladenburg & Co v. Goodwin Ferreira & Co Ltd (in liq) and Garnett [1912] 3 KB 275
- J. Rowe and Son Pty Ltd v. FC of T (1971) 124 CLR 421; 71 ATC 4157; (1971) 2 ATR 497