



TR 97/9 - Income tax: sale of wool

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Taxation Ruling

Income tax: sale of wool

other Rulings on this topic

TR 94/13

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*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 applies to taxpayers who are woolgrowers. For the purposes of this Ruling a 'woolgrower' is a person who grows and sells wool as part of a primary production business.
2. Those parts of the Ruling which deal with the timing of derivation of income do not apply to woolgrowers who, due to the nature of their activities, should appropriately return income from the sale of wool on a receipts basis.
3. The Ruling deals with:
 - (a) establishing when a woolgrower who returns income from the sale of wool on an earnings basis is considered to derive such income under section 25 of the *Income Tax Assessment Act 1936* ('the Act');
 - (b) establishing when wool ceases to be trading stock of the woolgrower for the purposes of the trading stock provisions in sections 28 to 37 of the Act; and
 - (c) outlining the options available to woolgrowers, under subsection 31(1) of the Act, for the valuation of wool as trading stock on hand at year's end.
4. The Ruling examines the taxation issues mentioned in paragraph 3, in the context of the main methods by which wool is sold, namely:
 - (a) sale by auction;
 - (b) sale by private treaty;
 - (c) sale by forward contract;
 - (d) sales of pooled wool; and

- (e) other sale types.

Ruling

Appropriate basis for returning income from the sale of wool

5. Taxation Ruling IT 321 endorsed the Commissioner's long standing practice of allowing woolgrowers the option of returning income, from the sale of wool sold at auction, in the year in which payment is received by the broker on the woolgrower's behalf. We are aware that that Ruling may have contributed to some misunderstanding within the industry as to whether woolgrowers should return income on a receipts basis or an earnings basis. It may not be possible to state a general rule applicable to all woolgrowers as to which method of returning income is appropriate. However, we think that, having regard to the nature of the trading activities, the earnings basis is the appropriate method under which most woolgrowers should return income from the sale of wool. Even so, there may be limited circumstances in which the receipts basis will give a 'correct reflex' of a woolgrower's taxable income (see paragraphs 33 to 41).

Sale of wool on an earnings basis

6. Under the earnings basis income is derived by the woolgrower once the sale proceeds have been earned, in the sense that the woolgrower has performed all obligations necessary under a sale of wool contract in order to become entitled to receive the payment of an ascertainable sum. In other words, the woolgrower has become entitled in this way to a fixed amount owing, or a debt, in respect of the sale of their wool. Such an amount need not be immediately payable (see paragraphs 42 to 46).

Trading stock principles applicable to wool

7. The primary test for determining when wool ceases to be trading stock on hand of the woolgrower is whether the woolgrower has lost dispositive power over the wool. This will usually, but not always, coincide with the time when property in the wool passes to the buyer (see paragraphs 47 to 51).

8. Subsection 31(1) allows woolgrowers to value wool on hand at either its 'cost price', 'market selling value' or the 'cost of replacement'. Where a woolgrower receives a written valuation for wool which is placed into storage, this valuation may be accepted as the 'market

selling value' unless there is a material variation between the market price of the wool at the time of entering storage and the market price at the end of the income year (see paragraph 53).

9. For the purposes of valuing wool at cost price, all outgoings incurred up to the end of the tax year, which are directly attributable to the wool on hand, should be taken into account in determining the cost. These outgoings will typically consist of expenses associated with shearing, classing and baling. Expenditure associated with the general maintenance of stock or grazing land should not be allocated to the cost of wool on hand (see paragraphs 52 to 56).

Taxation consequences of the different methods of sale

Sales by auction

10. When wool is sold at auction, property passes to the buyer at the fall of the hammer and a debt for an ascertainable sum is created. It follows that income is derived at the fall of the hammer (see paragraphs 58 to 70).

11. As the woolgrower loses title and dispositive power over the wool at the fall of the hammer, the wool ceases to be trading stock of the woolgrower (see paragraph 62).

Sales by private treaty

12. Private treaty sales may be divided into 'spot' sales and 'consignment' sales. Although the terms of private treaty spot sales vary from contract to contract, a debt in relation to most sales will not be fully quantified until the wool, having been delivered to the premises of the private treaty merchant, is weighed and tested by the Australian Wool Testing Authority (see paragraphs 71 to 73).

13. In the usual situation, where the price of the wool is dependent on test results, we consider that income is derived once the test results have been received by the merchant. At this time, the price of the contract is fully ascertained, and the merchant has accepted the wool and owes the woolgrower an amount equal to the price. The fact that a sale contract may provide that property in the wool does not pass to the merchant until payment is made does not, in our view, delay the time at which income is derived (see paragraphs 74 and 82 to 90).

14. Where the woolgrower does not receive documentation or other advice from the merchant which identifies the date on which test results are received, we will accept that such a date may be approximated by substituting a date which is 10 days after the delivery date (see paragraph 75).

15. In situations where the price of the wool is not dependent on test results, we consider that income will be derived once the wool has been weighed. It is then that the amount owing to the woolgrower will be ascertained (see paragraph 77).

16. In a consignment sale situation, delivery, weighing and testing normally occurs prior to a sale contract being entered into. Income will therefore be derived when the contract is made (see paragraphs 79 to 81).

17. The practical effect of private treaty spot contracts is that the woolgrower loses dispositive power over the wool once it has been delivered to the private treaty merchant. Consequently, we consider that the wool then ceases to be trading stock of the woolgrower. When the sale is by consignment, the woolgrower retains dispositive power after delivery; the wool remains trading stock of the woolgrower until a sale contract is entered into (see paragraphs 78 and 81).

Sales by forward contract

18. We do not consider that there has been a sale of wool when a forward contract is made. In addition, the amount of the debt will not then be fully ascertainable. Sales by forward contract are essentially a specialised form of private treaty sale. Consequently, for the reasons given in paragraph 13, income is generally derived when the buyer, having taken delivery of the wool, receives the results of testing (see paragraphs 91 to 100).

19. Where the woolgrower does not receive advice from the merchant which identifies the date on which results are received, we will accept that such a date may be approximated by substituting a date which is 10 days after the delivery date (see paragraph 101).

20. Income will be derived upon weighing in respect of those sales where the price is not dependent on testing (see paragraph 102).

21. For similar reasons to those given in paragraph 17, we consider wool ceases to be trading stock of the woolgrower when the wool is delivered to the buyer (see paragraphs 103 and 104).

Sales of pooled wool

22. Payments made to a woolgrower from a pool, in advance of the final payment, are usually income and derived when the pool operator declares them. This will normally be immediately before, or at the same time as, the payment is received. However, no income is derived

if the payment takes the form of a loan to the woolgrower made available on commercial terms.

23. Income from the final payment is derived once the grower becomes contractually entitled to it under the terms of the pooling arrangement. This is generally when all wool in the pool has been sold and all the variables required for the calculation of the amount due to the grower are known. Normally, this occurs just before the final amount due is declared by the pool operator (see paragraphs 113 and 114).

24. The pooling contract creates a relationship of principal and agent between the grower and the pooling operator. While in the pool the wool remains identifiable as the property of the grower. It is only when the pool operator enters into sales contracts on behalf of the grower that the grower finally loses dispositive power over the wool. It is then that wool ceases to be trading stock on hand of the woolgrower (see paragraph 115).

Other sale types

25. The principles outlined in this Ruling may be applied to other methods by which wool is sold. For example, we are aware that some woolgrowers sell their wool overseas through a company which arranges for the wool to be processed in 'top' form and sold on the overseas spot market. The woolgrower receives an advance payment prior to shipping, based on a percentage of the value of the unprocessed wool, and receives a final payment once the wool is sold (see paragraphs 116 and 117).

26. Applying the principles discussed in this Ruling, our view is that:

- the woolgrower loses dispositive power, and hence the wool ceases to be trading stock on hand, upon delivery to the operator company;
- a fully ascertainable debt arises, and hence income is derived, in relation to the advance payment when the valuation is carried out; and
- income from the final payment is not derived until the company performs all the necessary calculations and declares what the amount will be (see paragraphs 118 and 119).

Date of effect

27. This Ruling applies to the 1996-97 and later income years for income derived by taxpayers to whom paragraph 2 does not apply. For wool which is trading stock on hand, this Ruling applies to years of income commencing both before and after its date of issue. However, this Ruling does not apply to taxpayers to the extent that it conflicts with the terms of 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).

28. Notwithstanding paragraph 27, we believe this Ruling correctly reflects the law concerning derivation of income as it has been for a number of years. A woolgrower may therefore request that this Ruling apply to an earlier year. Assessments for earlier years may be amended to give effect to this Ruling, to the extent permitted by section 170 of the Act.

Previous Rulings

29. This Ruling replaces Taxation Ruling IT 321, which is withdrawn. To the extent that the Commissioner's views in IT 321 still prevail, they have been incorporated in this Ruling.

Consequence of the withdrawal of Taxation Ruling IT 321; double wool clips

30. There have been suggestions that the withdrawal of Taxation Ruling IT 321 will expose some taxpayers who habitually sell their wool by auction in late June to assessment on the income from two wool clips in the transitional year. This view is based on the contention that income from late June 1996 auction sales would be derived, under IT 321, in early July 1996, while income from late June 1997 sales would be derived at the time of sale due to the introduction of this Ruling.

31. Similar issues were discussed in *Henderson v. FC of T* (1970) 119 CLR 612; 70 ATC 4016; (1970) 1 ATR 596, where Barwick CJ said at CLR 649; ATC 4019; ATR 600:

'...there cannot be any warrant in a scheme of annual taxation upon the income derived in each year of taxation for combining the results of more than one year in order to obtain the assessable income for a particular year of tax.'

32. Woolgrowers who have consistently returned income in accordance with Taxation Ruling IT 321 can continue that practice for the year ended 30 June 1996. This means that if the proceeds from a sale of wool by auction are not received by the broker before the end of that income year those proceeds are not assessable income of that year. Some woolgrowers will now have to consider, as a result of this Ruling, whether they should be returning income from the sale of wool on an earnings basis. Woolgrowers who change from a receipts to an earnings basis for the 1996-97 income year, the 'transitional year', do not derive assessable income for this year from the sale of wool at auctions held in the previous year. That is, woolgrowers who habitually sell in late June still effectively derive income from only the one wool clip in the transitional year (see also paragraphs 69 and 70).

Explanations

Appropriate basis for returning income from the sale of wool

33. The leading case on the question of whether a receipts basis or an earnings basis of returning income is more appropriate for a taxpayer is *The Commissioner of Taxes (SA) v. The Executor Trustee and Agency Company of South Australia Limited* (1938) 63 CLR 108 (*Carden's case*). Here, Dixon J said at 152 that the answer to a question of this type is:

'... governed by the principles recognized or followed in business and commerce, unless the legislature has itself made some specific provision affecting a particular matter or question.'

Which of the methods of accounting should be applied depends upon an inquiry as to which method is:

'... in the circumstances of the case calculated to give a substantially correct reflex of the taxpayer's true income' (at 154).

34. At 155 Dixon J quoted from Sir Houldsworth Shaw and Mr Baker's *Law of Income Tax*, p111:

' "There is an important distinction between debts due to a trading company and unpaid in a particular year or period and other income which is not a trade receipt. Trading debts due but not yet paid must be included in arriving at the balance of profits or gains." '

35. In the same case, Latham CJ said at 123:

'In the case of traders, where tax is imposed upon the profits of a trade, profits are calculated both in Australia and in England on

an earnings basis; that is to say, the trade debts which fall due to the taxpayer during the year are credited and allowance is made for bad debts.'

36. Wool which is grown for sale falls within the definition of 'trading stock' in subsection 6(1) of the Act. We consider wool also falls within what Mason J described in *FC of T v. St Hubert's Island Pty Ltd (in liq)* (1978) 138 CLR 210 at 226; 28 ATC 4104 at 4112; (1978) 8 ATR 452 at 461 as 'accountants and commercial men's ... use of the expression "trading stock" '.

37. Sections 28 to 31 ensure that movements in trading stock are taken into account in arriving at a woolgrower's taxable income. The use of an earnings basis of returning income, in tandem with the trading stock provisions, generally gives a more correct reflex of a woolgrower's income than a receipts based system. This point may be best illustrated by considering an example of a first year woolgrower's activities:

Grazier A ventures into the business of wool growing late in calendar year 19X1. In May 19X2, \$20,000 of shearing expenses are incurred. Throughout the year \$30,000 of additional expenses relating to the wool growing activities are incurred. In late June 19X2, the resultant wool is sold at auction for \$110,000. Payment is received by A in July 19X2. In calculating the net income for the year ended 30 June 19X2 from the woolgrowing business, we can say the following:

- *\$50,000 of expenses have been incurred;*
- *no amount is assessable under subsection 28(2) as there is no trading stock on hand as at 30 June 19X2.*

A receipts based system produces a loss of \$50,000 even though the wool has been sold during the income year. An earnings based system gives a taxable income of \$60,000, which accurately reflects the activities which have taken place throughout the year.

38. The comments of Menzies J in *J Rowe and Son Pty Limited v. FC of T* (1971) 124 CLR 421 at 448; 71 ATC 4157 at 4158; (1971) 2 ATR 497 at 499 are also illustrative:

'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.'

39. The view that income from the sale of wool should be returned on an earnings basis found support in Taxation Board of Review *Case L12* 11 TBRD 68; *Case 45* 9 CTBR (NS) 289. At issue was the time at which income from the sale of wool by auction is derived. Mr RE O'Neill, at TBRD 75-76; CTBR 296, made the following observation, which supported the comments made by Messrs JL Bourke (chairman) and RC Smith QC, at TBRD 71; CTBR 293:

'When one considers the plan of the present Assessment Act, I think the conclusion is inevitable that on the reasoning in *Carden's Case* the appropriate system of measuring the income of a pastoral or grazing business is the accruals system, there being no contrary provision in the legislation.'

40. Whether the earnings basis gives a 'substantially correct reflex' of a woolgrower's true income from the sale of wool will depend on the circumstances in which each woolgrower conducts this income producing activity. Relevant factors include how the woolgrowing and selling are carried out and what records and books of account are kept. Accounting and commercial principles may also provide a guide.

41. '[R]egard must be had to the nature and particular circumstances of the taxpayer's income and enterprise' (per Davies J in *FC of T v. Dunn* 89 ATC 4141 at 4147; (1989) 20 ATR 356 at 362). However, in most cases, particularly for larger enterprises, the proper conclusion will be that the earnings basis is the correct method of determining what income has been derived in a particular accounting period for a particular woolgrower.

Consequences of returning income on an earnings basis

42. The earnings basis of returning income requires that a taxpayer determine when each item of assessable income is **derived**. There is considerable case law on the subject of **derivation** of income. In *FC of T v. Australian Gas Light Co & Anor* (1983) 52 ALR 691 at 698; 83 ATC 4800 at 4805; (1983) 15 ATR 105 at 111, Bowen CJ, Fisher and Lockhart JJ described some of the tests that have been adopted by the courts:

'The fees of accountants are derived when they have matured into recoverable debts: *Henderson v. F.C. of T.* 70 ATC 4016; (1970) 119 C.L.R. 621. Fees paid in advance for provision of dancing lessons are not derived until they are earned: *Arthur Murray (N.S.W.) Pty. Ltd. v. F.C. of T.* (1965) 114 C.L.R. 314; (1965) 14 A.T.D. 98. The income of a trading business is derived when its stock is sold and a debt is created: *Rowe J. &*

Son Pty. Ltd. v. F.C. of T. 71 ATC 4157; (1971) 124 C.L.R. 421.'

43. In reference to these tests, their Honours went on to say, at ALR 698; ATC 4805; ATR 111:

'Helpful as these tests may be as signposts, each of them has been conceived in and applied to varied and contrasting circumstances. As signposts they indicate that invariably something more than provision of goods or services by the taxpayer is required. **It is necessary to determine whether the consequence is that a debt has been created or whether the taxpayer is obliged to take further steps before becoming entitled to payment.**' (emphasis added)

Thus, in *Australian Gas Light Co* the inquiry was into whether the taxpayer's claims against customers for gas supplied but not yet billed had matured into recoverable debts (ALR 699; ATC 4806; ATR 112). It was held that they had not as, because of the relevant statutory provisions and regulations, the taxpayer was not entitled to receive payment before the reading of each customer's meter.

44. In *Gasparin v. FC of T* 94 ATC 4280 at 4287; (1994) 28 ATR 130 at 138, von Doussa J noted:

'The element of contingency is an important one. In *Barratt & Ors v FC of T* 92 ATC 4275 at 4281-4282; (1992) 107 ALR 385 at 393-394 [; (1992) 23 ATR 339 at 346] Gummow J, with whom the other members of the court agreed said:

"No doubt a debt that is presently recoverable by action generally will be an amount 'derived' in the relevant sense by the creditor. The creditor will have a present right to receive the amount in question, something both earned and quantified, without the presence of any element of contingency or defeasibility. At the other end of the scale, where the right of the taxpayer is contingent, there will be no derivation before the contingency is satisfied: see Parsons, *'Income Taxation in Australia'*, paragraph 11.49. Nor will there be derivation if the debt is yet to be quantified: *Farnsworth v FC of T* (1949) 9 A.T.D. 33 at 37; (1949) 78 C.L.R. 504 at 513 per Latham C.J."'

45. This passage from the judgment of Gummow J identifies two elements which we think are critical to determining whether income has been derived under the earnings method from a sale of goods. Firstly, the income must have been 'earned' in the sense that the seller has done all that they need to do to become entitled to payment, even though they may not have any cause of action at that time in relation to that debt (*Barratt* at ALR 396-397; ATC 4284; ATR 349). Secondly,

there needs to be a debt in the sense that the amount to be paid for the sale of the goods exists as a sum presently owing to the seller and has been fixed. It does not matter that this debt may not be recoverable by action until some future date. The decision in *Barratt* illustrates the distinction between a condition precedent to the existence of a debt and an impediment to the collection of such a debt.

46. Income from the sale of wool should not be treated as being derived unless there is certainty about the amount which is owing to the woolgrower as a result of the sale. We think that such income is derived when the woolgrower, as seller under a contract of sale, has performed all their obligations as required by the contract in order to become entitled to payment of a fully ascertained amount. This may occur before or after property in the wool passes to the buyer, depending on the terms and conditions of sale.

Trading stock principles applicable to wool

47. Section 28 of 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. While wool generally only ceases to be trading stock of the woolgrower once property in the wool has passed to a buyer, this may not always be the case.

48. The primary test is whether the woolgrower has lost dispositive power over the wool. This test was developed in *Farnsworth v. FC of T* (1949) 78 CLR 504; (1949) 9 ATD 33 and followed in *FC of T v. Suttons Motors (Chullora) Wholesale Pty Ltd* (1985) 157 CLR 277; 85 ATC 4398; (1985) 16 ATR 567 and *All States Frozen Foods Pty Ltd v. FC of T* (1990) 21 FCR 457; 90 ATC 4175; (1990) 20 ATR 1874.

49. The loss of dispositive power principle also received the support of von Doussa J in *Gasparin* in his discussion of *Farnsworth*. In his judgment, von Doussa J also considered the nature of the relationship between the concepts of 'trading stock on hand' and 'derivation of income'. At ATC 4288; ATR 139 he said:

'The [*Farnsworth*] decision, in my opinion, does not support the Commissioner's argument that notions of matching require a loss of dispositive power ... to be balanced at the same time by treating as derived income profits expected to be received at a later date under the unsettled contracts of sale. On the contrary I think the decision is against the argument.'

50. These comments highlight the fact that there are exceptions to the rule that the point of income derivation normally coincides with the time trading stock ceases to be on hand. Such a situation is

discussed in Taxation Ruling TR 94/13, which examines trading stock and income derivation issues in the context of the cotton industry. In pool marketing arrangements, it is often the case that cotton ceases to be trading stock on hand of the grower before income is derived.

51. In *Farnsworth* the taxpayer had delivered dried fruit to a packing house to be mixed with the produce of other fruit growers and ultimately be sold. As the taxpayer had lost all power to direct or control the disposal of the fruit, the fruit ceased to be trading stock on hand upon delivery to the packing house. However, the full sale proceeds were not derived until some later time when the co-operative made a final distribution in relation to the sale of the fruit.

Valuation

52. Growers who find they have wool on hand as at year's end will be faced with the decision of how that wool should be valued. Although subsection 31(1) allows for one of three methods to be used, for wool the choice will usually be market selling value or cost price.

53. Where a woolgrower receives a written valuation for wool which is placed into storage, this valuation may be accepted as the 'market selling value' unless there is a material variation between the market price of the wool at the time of entering storage and the market price at the end of the income year. If wool prices move significantly after the wool is placed into storage, the market selling value will need to be calculated by reference to auction prices for comparable wool at the final auction sale of the income year.

54. In the case of woolgrowers who choose the cost price method, exactly what costs should be taken into account? Some guidance may be found in *Case D95* 4 TBRD 483; *Case 2* 4 CTBR (NS) 7, where the Board, although not required to decide the issue, made some comments about how wool might be valued under the cost price method. Mr FC Bock noted, at TBRD 491; CTBR 14:

'... the cost to (the taxpayer) of acquiring the wool as a separate marketable commodity begins to accrue from the time of mustering the sheep for shearing. Then follows shearing, classing and baling to bring the wool into a marketable state.'

55. Deputy Member RC Smith then observed, at TBRD 493; CTBR 17:

'A proportion (*inter alia*) of the following expenses shown in the profit and loss account would appear to be attributable to the second shearing, namely - wages (for mustering), wool expenses, stores (if the shearers were fed), petrol, etc. (for running the shearing plant, etc.) ... What proportion (if any) of

each item should be taken into account would no doubt vary, depending upon the item's connection with and referability to the actual operation of separating the wool from the sheep's back.'

56. The point which emerges is that the costs to be considered are those which are directly related to bringing the wool into existence as a separate item of trading stock. These expenses may be contrasted with outlays, such as general fencing costs, geared more toward the maintenance of the sheep as animals, which should not be allocated to the cost price of the wool for subsection 31(1) purposes.

Taxation consequences of the different methods of sale

57. Taxation Ruling IT 321 dealt only with the issue of derivation in the context of the sale of wool by auction. While most wool is still sold by auction, changing economic circumstances, particularly the collapse of the wool floor price system, have led to woolgrowers exploring other sale options in order to maximise returns and/or create a more stable income flow. This Ruling looks at how derivation of income and trading stock principles apply to the main methods of selling wool.

Sales by auction

58. Wool broking firms which conduct auction sales invariably adopt terms and conditions of sale which are similar to the Australian Wool Exchange's (AWE) recommended Member's Terms and Conditions of Sale. Clause 5(a) of the recommended terms and conditions states that the property and risk in the goods shall pass to the buyer on the fall of the hammer. This is consistent with the approach taken in the various *Sale of Goods Acts* and accords with common law principles (e.g., *Dennant v. Skinner* (1948) 2 KB 164; [1948] 2 All ER 29 and *McPherson, Thom, Kettle & Co v. Dench Bros* (1921) VLR 437; (1921) 27 ALR 272).

59. There will be circumstances where a sale which ostensibly has occurred at the fall of the hammer will not ultimately come to fruition. For example, sub-clause 3(d)(i) of the AWE recommended Terms and Conditions of Sale allows for a 'buyer in error' to have the wool lot resubmitted for sale if the error is notified before the sale of the 10 succeeding lots. The possibility of the buyer reneging is catered for in sub-clauses 6(h)(d) and (e), which allow the broker to resubmit wool which has not been paid for and provide that the buyer will be liable to the broker and vendor for any damage suffered.

60. The views of Messrs JL Burke and RC Smith in *Case L12; Case 45* at TBRD 72; CTBR 293 seem best to describe the arrangement:

'As at present advised we hold the view that on a sale by auction there comes into existence on the fall of the hammer a contract which is a valid contract even though it be voidable on the ground of fraud or misrepresentation and it remains a valid contract unless and until it is so avoided (see *Chitty on Contracts*, 21st ed., Vol. 1, at p. 533).'

61. A recoverable debt also comes into existence at the fall of the hammer. This is so even though the buyer generally has until the Friday following the week of the sale to make payment. The various *Sale of Goods Acts* provide that the seller may sue for the price once property in the goods has passed. The amount of this debt is fully ascertainable as the sale price and broker's commission will be known when the hammer falls. It follows that the woolgrower derives income then.

62. As property in the goods passes to the buyer on the fall of the hammer, or shortly thereafter, it is then that the woolgrower loses dispositive power over the wool. Up until this point the woolgrower has the opportunity to withdraw the wool from auction or, alternatively, the wool may simply fail to reach the reserve price. It follows that the wool ceases to be trading stock of the woolgrower at the time the hammer falls.

Alternative view

63. Following the release of the draft version of this Ruling, the view was put that the particular terms and conditions of a sale of wool by auction were such that these sales should be treated differently, for income tax purposes, from other sales of goods. This view is based on the fact that, even though property in the wool passes to the purchaser on the fall of the hammer, the broker retains possession of the wool until payment is received. Further, if the purchaser does not pay for the wool within a designated time, the broker is entitled to resell the wool on the woolgrower's behalf, with the original purchaser being liable to meet any shortfall following this subsequent sale. The contention is that, as the sale is not actually finalised and the purchaser is not assured of property in the wool until payment, income cannot be derived before this time.

64. Our view is that terms and conditions of sale which fundamentally relate to mitigating the woolgrower's possible exposure to bad debts are not relevant to the timing of derivation of income. On the day the hammer falls, the woolgrower has the right to receive a specific sum of money by a designated date and the buyer has immediate property in the wool and a right to possession which is subject to payment. The various *Sale of Goods Acts* confer on the

woolgrower, at this point, a right to sue for the price if payment is not forthcoming by the due date. Any subsequent events, such as a buyer default and the resale of the wool on the woolgrower's behalf, seem to us to be events which, while they may have their own income tax consequences, take place after the initial derivation of income has occurred. The terms and conditions of sale at wool auctions have not changed materially since *Case L12*; *Case 45* was decided and we see the reasoning which underpinned that decision as still being applicable.

65. An example should illustrate our view:

Grower A engages broker B to sell wool at an auction which is scheduled for 23 June 19X1. Buyer C is the successful bidder. Pursuant to the terms of sale and A's agreement with B, C is to pay B for the wool within 9 days and A is entitled to receive a net amount of \$25,000 within 14 days. C goes into liquidation and B resubmits the wool for sale. In 19X2, A receives \$22,500 as a result of the second sale and C is fully wound up with no assets to meet the auction shortfall.

66. We see the above scenario as having the following tax consequences:

- *Income of \$25,000 is derived by A on 23 June 19X1. As A also loses dispositive power over the wool at this date, the value of the wool does not form part of A's trading stock as at 30 June 19X1.*
- *Upon the resale of the wool, C's debt to A is reduced to \$2,500. This debt is written off during 19X2. As \$25,000 was returned as income in 19X1 and only \$22,500 received in 19X2, a deduction of \$2,500 is allowable to A under the combined effect of subsections 63(1) and 63(4) of the Act.*
- *Had the scenario provided for A to receive \$27,500 as a result of the resale, income of \$2,500, being the additional amount A is entitled to receive, would be derived on the day of the second auction and no part of the original debt of \$25,000 would be bad.*

67. The alternative view is, in fact, very similar to that expressed by this Office in Taxation Ruling IT 321. This view had its genesis in the early 1950s and derives from comments made before then by the late Dr Hannan in his *Principles of Income Taxation* (Law Book Co of Aust, 1946) at page 185:

'... where trading stocks are sold and delivered, the full price must be brought to account in the year in which the delivery is made, irrespective of the time of payment.'

68. The emphasis on 'delivery' was seen as important in the context of wool sales by auction where delivery to the purchaser only takes place after payment is made to the broker. It was considered a debt was created, and income derived, when the purchaser paid the broker. We now believe this view is incorrect and is not supported by case law.

69. It follows from the previous discussion that the 'Commissioner's long standing practice' outlined in IT 321 is premised on the assumption that the earnings basis is the correct basis under which most woolgrowers should return income. The difference between IT 321 and this Ruling reflects no more than a different view being taken about when a debt is created. While it can be said generally that, in the past, this Office has not actively sought to enter into disputes with taxpayers who have a contrary view, it has always been our position that income from the sale of wool should be returned by most woolgrowers on an earnings basis. Consequently, this Ruling does not effect a change in the view of this Office as to whether the receipts basis or the earnings basis is more appropriate for woolgrowers but does change our view as to the time the debt crystallises.

70. We do, however, accept that many readers may have interpreted Taxation Ruling IT 321 as endorsing the practice of returning income from auction sales on a receipts basis. For this reason we will not seek to dispute the matter with those taxpayers who, for the 1996-97 income year and before, have consistently interpreted IT 321 in this way: refer paragraphs 15 and 16 of Taxation Ruling TR 92/20 (see also paragraphs 27 to 32 of this Ruling).

Sales by private treaty

71. Unlike the auction system, where a wool broker acts as agent for the woolgrower who sells wool to a third party, private treaty sales involve a purchase by the private treaty merchant who subsequently on-sells the wool to a third party. Terms and conditions in private treaty contracts vary. In each case, these terms and conditions of sale are important in establishing when income is derived from the sale of the wool.

72. The standard 'spot' contract endorsed by the Private Treaty Wool Merchants of Australia provides that property in the wool passes upon payment. To allow for the receipt of test results, payment usually takes place about 14 days after the wool has been delivered to the merchant. The merchant carries the risk associated with the wool upon taking delivery, even though property has not yet passed.

73. Soon after delivery the wool is weighed and tested by the Australian Wool Testing Authority. After weighing and testing, the

price of the contract is fully ascertained. As Crisp J stated at in *Dawson v. Botten* (1952) 6 AITR 35 at 42; (1952) 10 ATD 252 at 258, when discussing the affairs of a wool trader:

'If the final amount of the debt or credit is not capable of precise ascertainment because it is subject to some adjustment ... then it appears it is not an ordinary ascertained trading debt to be brought to account in the year in which it begins to accrue.'

74. Income from the sale of the wool is considered to be derived immediately after the test results are received. By then the sale price will be fully ascertained, the merchant will generally have accepted the goods, and the woolgrower will have no more obligations to fulfil under the contract of sale in order to become entitled to payment. We recognise that it may not always be possible for woolgrowers to ascertain the day on which test results are received and this may provide a practical impediment to ensuring that income is treated as derived at the appropriate time.

75. Where the woolgrower does not receive documentation or other advice from the merchant which identifies the date on which results are received, we are prepared to accept that such date may be approximated by substituting a date which is 10 days after the delivery date. This substituted date takes into account that the Australian Wool Testing Authority generally undertakes to have the test results to the merchant within 10 days.

76. In those rare instances where the merchant rejects the wool upon receipt of the test results, or earlier and before indicating acceptance to the grower, income is not considered to have been derived. In this situation a new sale agreement generally needs to be negotiated. Income from the new sale is derived following delivery, acceptance and the setting of the new price.

77. In some instances the sale price of the wool is not linked to test results. This generally occurs when the merchant already has a sound knowledge of the quality of the wool before entering into the contract. In these instances derivation generally occurs upon weighing, which takes place soon after delivery. This is when the amount owing to the woolgrower is fully ascertained.

78. We consider that the woolgrower loses dispositive power over the wool at the time of delivering the wool to the merchant since the delivery of the wool constitutes the fulfilment of the woolgrower's obligations in respect of the contract of sale. The wool then ceases to be trading stock of the woolgrower.

Consignment sales

79. While spot sales are far more common than consignment sales, the selling flexibility consignment sales offer woolgrowers has seen their popularity increase in recent times. As this is a competitive area, terms and conditions of sale will vary but we believe the features outlined in the following paragraph will be present in most consignment sales.

80. Once the wool is delivered to the merchant's store, the woolgrower is levied a handling charge and pays for core testing to be carried out. The wool is not subject to further processing while in store. While it is uncommon in practice for woolgrowers to remove their wool, they are entitled to do so at any point before a sale. Once the merchant finds a buyer, the woolgrower is offered a price which may be accepted or rejected.

81. We consider that, under this 'consignment sale' scenario, a recoverable debt will come into existence immediately after the sale contract is entered into. The wool remains trading stock on hand of the woolgrower until a sale contract is entered into because the woolgrower has the ability to remove the wool until then.

A contrary view

82. We are aware of contrary views relating to 'spot' sale contracts which contain clauses purporting to retain title in the wool for the woolgrower until payment is made. These are known as '*Romalpa* clauses' or 'retention of title clauses'. They are commonly used to minimise the risks to a seller if the buyer in possession of goods becomes unable to make payment. Despite the rise in incidence of *Romalpa* clauses in all types of sale of goods contracts, there is no case law on the issue of when income is derived under a contract containing such a clause.

83. On one view, income cannot be derived from the sale of goods prior to property passing because the sale is not complete. We were referred to subsection 48(1) of the *Sale of Goods Act 1895* (SA) ('the SA Act'), which has counterparts in all Australian states and territories and in the United Kingdom. It states:

'Where, under a contract of sale, the **property in the goods has passed to the buyer**, and the buyer wrongfully neglects or refuses to pay for the goods according to the terms of the contract, the seller may maintain an action against him for the price of the goods.' (emphasis added)

84. It has been contended that, since no action for the price would be available for goods under subsection 48(1), a recoverable debt cannot

exist prior to property passing. We do not agree that such an outcome is inevitable. For example, *Chalmers' Sale of Goods Act* (18th ed) at page 225 states the following:

'In principle there seems no reason why the rules of common law should be excluded by [the UK counterpart to section 48 of the SA Act], and there is some authority that where a contract clearly provides for the unconditional payment of the price in given circumstances which arise, then the seller may claim for the price. **Thus, if the buyer has accepted delivery and not rejected the goods, payment being 90 days after delivery, and there being a provision that property should not pass until payment, the seller cannot claim damages for non-acceptance for the buyer has accepted the goods, and there seems no good reason why he should not claim the price.**' (emphasis added)

85. The idea that a seller may sue a defaulting buyer for the price, even though property has not yet passed, also finds support in cases dealing with the sale of goods by instalments. *Sandford v. Dairy Supplies Ltd* [1941] NZLR 141 provides some authority for the view that the seller under this type of contract is entitled to sue a defaulting buyer for the full price, even though property has not passed, provided that the buyer has taken delivery of the goods. A similar conclusion was reached in *Alexander Knox McEntire and John Arthur Maconchy v. Crossley Brothers Limited* [1895] AC 457 where Lord Herschell said, in reference to what amounted to a 'rent to own agreement', that the seller would have a right to the balance of the price as a debt due, with the purchaser keeping the goods.

86. It is clear that the sale of goods legislation was not framed with sales contracts containing retention of title clauses in mind. Where the specific legislation does not provide for a suitable remedy in the event of a buyer default, it is reasonable to conclude that the seller's cause of action may be founded on general common law principles.

87. In any event, while the woolgrower's ability to sue for the price of the wool in the event of the merchant defaulting depends on the exact contractual arrangement and the actions of each party, we think that for the purpose of determining when income is derived the enquiry should be directed toward whether or not the income has been **earned** in the sense discussed in cases such as *Henderson, J Rowe & Son Pty Ltd* and *Barratt*. In particular, the argument that derivation of income cannot occur because it is said there is no action available for the price of the goods until property in the goods has passed, seems to us to overlook the significance of the decision in *Barratt*. In *Australian Gaslight Co* the Full Federal Court said, at ALR 698; ATC 4805; ATR 111:

'Conversely, fees for the price of goods sold are not earned, and thus not derived, if a further step is required before the taxpayer is entitled to payment: *Rowe's case*.'

88. In the current context, the final step required of the woolgrower will be the delivery of the wool to the merchant. By then, the woolgrower has earned the right to the payment of an as yet unspecified amount. The process of fully ascertaining the price is a condition precedent to the liability on the part of the merchant to pay for the wool. Until this happens, the second element required for there to have been income derived is not present. The amount of the merchant's liability is fully ascertained, however, upon receipt of the test results. At this time the merchant can be considered to have accepted the wool either by explicit acknowledgment to the grower or by virtue of the wool not being rejected. We consider the presence of the three elements - the delivery of the wool, acceptance by the merchant and ascertainment of the price - is necessary and sufficient for there to be a recoverable debt owing to the grower, even if property in the wool has not yet passed.

89. The derivation of income from the sale of goods should be contrasted with the derivation of income from the sale of real property. It was held in *Gasparin* that income from the sale of land was not derived until settlement had taken place. We do not think that von Doussa J's decision was based on the fact that legal ownership in the land would not be transferred until settlement. The explanation for the judgment rather lies in the realisation that a vendor in a real property transaction will not have performed all that is needed to become entitled to payment prior to settlement. At settlement, transfers are effected which put the purchaser in a position to become registered as owner. As such, the vendor does not earn the income from the sale until settlement.

90. We think that the approach taken to income recognition in this Ruling is both consistent with commercial reality and ensures consistency of treatment between woolgrowers. For example, it was not uncommon in the recent past for 'spot' contracts to provide that property passed as soon as the wool was delivered to the merchant. In these circumstances, clearly income would be derived prior to payment. While the insertion of *Romalpa* clauses in such contracts has now become commonplace, to safeguard the interests of woolgrowers, there appears to have been no material change in how the wool is physically dealt with by merchants.

Sales by forward contract

91. Forward contract sales are essentially a specialised form of private treaty sale whereby the woolgrower undertakes to deliver a quantity of wool, usually from a designated flock of sheep, to the merchant at some time in the future. It is normally the case that the contracted wool is still 'on the sheep's back' at the time of making the contract. The ultimate value of the contract to the woolgrower will be subject to the quantity and class of wool finally delivered.

92. The case of *FC of T v. Woolcombers (WA) Pty Ltd* 93 ATC 5170; (1993) 27 ATR 302 established that, from the buyer's point of view, expenses associated with purchasing wool by forward contract may be deductible at the time of making the contract. That is, the decision demonstrates that the buyer can be subject to a presently existing liability because of such a contract, even though the debt is not to be discharged until some time in the future.

93. It does not follow that income is derived by the woolgrower at the same time. The concepts of when expenses are incurred and when income is derived are not necessarily symmetrical, even where both the buyer and seller of wool return income on an earnings basis.

94. One impediment to income being derived at the time of the contract is that the unshorn wool which is the subject of most forward contracts is considered to be unascertained goods (see *Halsbury's Laws of Australia*, 375-910). Since the goods do not exist in the form in which they will ultimately be sold, it is difficult to envisage a situation whereby income could be derived from the sale at this point.

95. By way of contrast, it is not unusual for the terms of a forward contract to stipulate that property in the wool will not change until payment has been made in respect of the contract. This is normally after the woolgrower has delivered the wool to the purchaser. For reasons similar to those given at paragraphs 81 to 89, we consider the time of payment, and hence the time the property in the wool actually passes, is not relevant to the timing of derivation of income from the sale of wool.

96. Rather, what is important is that the income has been earned through the woolgrower performing their obligations and a debt has been quantified because the price has become fixed. The proceeds from the sale of the wool need to be an amount presently owing to the woolgrower, even though they may only become payable at some future date (see, for example, *Rowe's* case at CLR 450; ATC 4160; ATR 500). It is also clear from *Barratt's* case that there is no bar to income having been derived even though the amount owing may not be presently recoverable by action (at ALR 396; ATC 4284; ATR 349).

Two main types of forward contract

97. Forward contracts for the sale of wool can be conveniently classified as fixed contracts or variable contracts. Variable contracts are often referred to as 'rise and fall' contracts. A variable contract contains a base price per kilogram of wool but this price is subject to adjustment depending on the micron level and vegetable matter content of the wool delivered. The actual quantity of wool is also subject to variation since the wool is unshorn when the contract is made.

98. It is only after the Australian Wool Testing Authority weighs and tests the wool that all necessary calculations can be made to quantify the price payable to the woolgrower under the contract. It is then that income is considered to have been derived.

99. Under a fixed forward contract there is a greater degree of certainty in regard to some of the variables which form the sale price. In particular, the price to be paid per kilogram of wool is set. However, until the wool is weighed and tested the overall sale price can usually only be estimated. Until then, the precise quantity of wool being sold is usually not known. In addition, the price per kilogram may be subject to variation where the quality of the delivered wool does not fall within a range designated in the contract.

100. In summary, under both a fixed and a variable forward contract for the sale of wool, a 'sale' does not take place when the contract is made, since unshorn wool constitutes unascertained goods. Shearing is a necessary prerequisite to the sale price being quantified, since the wool cannot be weighed or tested until it has been shorn. It is normally after weighing and testing that the woolgrower earns an entitlement to a fully ascertained amount in respect of the sale. This is so regardless of any stipulation in the contract to the effect that property in the wool passes upon payment (see paragraphs 81 to 89).

101. As outlined in paragraph 75, this Office will accept a date that is 10 days after delivery as approximating the date the test results are received if the woolgrower does not have ready access to a more precise date.

102. We are aware that under some fixed forward contracts the price of the wool is not subject to testing. In these circumstances the price is fully ascertained, and income derived, immediately after the wool is weighed.

103. Upon entering into a forward contract a woolgrower is substantially committed to the delivery of, as yet, unascertained goods to the purchaser. On one view, such wool ceases to be trading stock immediately upon its ascertainment - when the sheep are shorn. The

facts in *Woolcombers* possibly support this view. Evidence was given in *Woolcombers* that between 1976 and 1988 only one of the forward contracts entered into by the wool buyer was not completed.

104. However, until the wool is actually delivered, the woolgrower has the right to sell the wool to another buyer, with the other party to the forward contract being entitled to indemnification from the woolgrower for any loss suffered. Here, it is clear that dispositive power is not finally relinquished until delivery of the wool. The wool then ceases to be trading stock on hand of the woolgrower.

Sales of pooled wool

105. Pooling schemes, although common in the cotton, grain and milk industries, are still comparatively new in the wool industry. When discussing terms and conditions of contracts associated with pooling schemes, it is difficult to speak of 'industry norms' since this method of selling does not have a long history of activity. While details of the arrangements may change over time, we consider that the main features of these schemes are unlikely to change materially in the near future and the views expressed in this Ruling are given on this basis.

106. From the woolgrower's point of view, pooling schemes are essentially a risk management instrument whereby the woolgrower receives an averaged return based on the total income over the life of the pool. The pool operator, in the schemes we are aware of, does not buy the wool from the woolgrower but, rather, acts as agent for the woolgrower in the sale of the wool. All woolgrowers participating in the pool, upon delivering wool in accordance with the pooling contract, give the pool operator irrevocable authority to deal with and sell the wool in accordance with that contract. Title in the wool will not pass upon delivery of the wool to the pool operator, but rather at some later time when the wool is sold to a third party.

107. The pooled wool is insured on behalf of the woolgrower by the pool operator. In the event of fire in the wool store, the proceeds of any insurance claim are incorporated into the pool proceeds, rather than being paid directly to the affected woolgrowers.

108. The pool operator may choose to sell the wool by auction, private treaty, forward contract or a combination or variation of any of these methods. From the perspective of the woolgrower it is **not** important to establish when the buyer owes a fully ascertainable debt to the pool itself. This is not a debt which is owed directly to any particular grower. Rather, it is important to establish when the pool operator can make all the necessary calculations under the pooling

contract to ascertain the amount of the debt owed to all participants in the pool.

109. Normally, the pool operator makes the required calculations as soon as the relevant information comes to hand. Once these calculations are made, a final distribution is declared. In these circumstances we accept that income is derived by the grower at the time the final distribution is declared. This is normally shortly before the final payment is made to the grower. Under some pooling contracts a debt is due to the grower when all the relevant information is known, even though calculation of the amount owing is deferred. In such a case, income may be derived before any final distribution is declared. Whether or not this is so will depend on a proper examination of the pooling arrangement.

110. The pool operator sometimes makes one or more advance payments to the woolgrower, usually based on the percentage of the likely sale price. The final distribution is net of these payments.

111. A debt is established in relation to any advance payments when the pool operator declares such an amount. This is shortly before or at the time of making payment. Even though the woolgrower's wool is usually unsold at the time of declaring the advance payment, the advance payment is made as a consequence of the inevitable future sale of wool. This sale is, as a matter of commercial reality, certain to take place. Further, as the woolgrower has irrevocably delivered the wool to the pool operator for ultimate sale, we do not consider the payment is income not yet earned as in *Arthur Murray (NSW) Pty Ltd v. FC of T* (1965) 114 CLR 314; (1965) 14 ATD 98.

112. We consider that woolgrowers derive income from advance payments made by pool operators when the payments are declared. This view accords with the treatment of the progress payments which was accepted by both parties in *Farnsworth*.

113. Advance payments should not be confused with woolgrower loans in which the pool operator acts as lender. Loan funds are not assessable income of the woolgrower. In order to be accepted as a legitimate loan, such funds need to be made available to the woolgrower on a commercial basis. It is expected that such loans are repayable, interest bearing and supported by appropriate documentation. Where these elements are not present, funds received by the woolgrower from the pool operator are treated as assessable advance distributions.

114. In summary, a woolgrower generally has multiple income derivation points under a pooling contract. Advance payments and the final payment are normally derived when the pool operator declares

such amounts. In practice, this is generally shortly before such amounts are received by the woolgrower.

115. While the pooling operator has authority to deal with the wool on the grower's behalf in accordance with the contract, the relationship essentially remains one of principal and agent. The wool is not committed to any particular buyer until sale contracts are entered into. Further, unlike the fruit in *Farnsworth*, the wool remains in bales until sold and, in that form, is clearly identifiable as the property of each individual grower. Accordingly, we consider that the grower does not finally lose dispositive power over the wool until the pool operator enters into sale contracts on the grower's behalf. It is then that the wool ceases to be trading stock on hand of the grower.

Other sale types

116. The methods by which wool is sold are continually evolving and it is simply not possible for a Ruling of this nature to provide specific guidance in relation to all of these sales types. **However, we think that the principles outlined in this Ruling are readily adaptable to each sale situation. In relation to each arrangement, the following key times need to be established:**

- **when, during the sale process, a right to a recoverable debt comes into existence; and**
- **when the woolgrower finally loses dispositive power over the wool.**

117. As a further example, these principles can be applied to the following scenario about a company which arranges for woolgrowers to have their wool processed in 'top' form and sold overseas. The steps, as we understand them, are as follows:

- woolgrower delivers wool in bales to company in accordance with a sale contract;
- company generally accepts woolgrower's figures as to the weight of the wool;
- a ship is scheduled to carry the wool;
- the wool is tested by the AWTA (but not weighed);
- Wool International assesses and values the wool. The valuation is based on the most recent Sydney auction. The valuation takes place as close as possible to the shipping date - usually about two weeks before shipping;

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- woolgrower receives a letter of valuation enabling the woolgrower to calculate the amount of any initial payment (see below);
- if there is a delay in shipping, the valuation may need to be repeated as wool tax is payable on the value as at shipping (in practice there never is a shipping delay because valuation does not take place until a definite date has been booked);
- at the time of shipping the woolgrower is given an advance payment equal to 35% of the assessed value of the unprocessed wool;
- property in the wool passes at the time of this advance payment;
- the wool is shipped to Europe and processed in 'top' form;
- it is then sold on a 'spot' market. Generally wool is sold in bundles according to grade. Each bundle may contain the wool of multiple woolgrowers, so each woolgrower may not have all 'his/her' wool (actually the wool is no longer the property of the woolgrower) sold at one time;
- once all wool is sold, a calculation is made as to what the woolgrower is owed, based on a mean price multiplied by quantity;
- the woolgrower is paid the balance of the amount owing, with the woolgrower receiving an advice of the amount owing shortly before payment is received.

118. The first point to note is that this arrangement, like a standard pooling arrangement, may involve multiple points of derivation. When the advance payment is derived will depend on the exact wording of the contract. Where the contract stipulates that the woolgrower is entitled to 35% of the valuation of the unprocessed wool, this income is derived at the time the woolgrower receives the notice of valuation. Where the contract does not specify an exact percentage, the income is only derived when the organising company declares a precise amount is owing. This would usually be on or shortly before payment. Similarly, the final payment is derived after all the post sale calculations have been made and a precise amount declared.

119. We consider that the woolgrower loses dispositive power once the wool has been delivered to the operator company. This is so even though property in the wool does not pass until the advance payment is made.

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