


TR 96/D5 - Income tax: conditional contracts/delivery of goods on sale or return: derivation of income; allowable deductions; trading stock on hand

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Draft Taxation Ruling

Income tax: conditional contracts/delivery of goods on sale or return: derivation of income; allowable deductions; trading stock on hand

other Rulings on this topic

**IT 2325; IT 2472; IT 2670;
TD 95/48; TD 95/D15**

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What this Ruling is about

Class of person/arrangement

1. This Ruling considers:
 - (a) when income is derived under subsection 25(1) of the *Income Tax Assessment Act 1936* (the Act) by the seller of goods under a conditional contract or when goods are delivered on sale or return;
 - (b) when a purchaser of goods under a conditional contract or of goods delivered on sale or return is entitled to a deduction under subsection 51(1) of the Act for an outgoing incurred in acquiring the goods;
 - (c) whether a seller of goods under a conditional contract is entitled to a deduction under subsection 51(1) when goods are returned by the purchaser and the seller repurchases the goods and either credits or refunds the sale price;
 - (d) whether, when a purchaser of goods under a conditional contract has incurred an outgoing under subsection 51(1) in acquiring the goods, the purchaser derives income when the goods are later returned to the seller;
 - (e) whether goods which are delivered under a conditional contract or on sale or return are 'trading stock on hand' of the seller or of the purchaser under section 28 of the Act.
2. This Ruling deals only with those cases where:
 - (a) the trading income of the seller or of the purchaser is assessable on an accruals, rather than a cash, basis; and
 - (b) the goods delivered under a conditional contract or on sale or return are trading stock, either in the hands of the seller or of the purchaser.

Definitions

3. This Ruling uses the terms '**conditional contract**' and '**goods delivered on sale or return**'. These terms refer to different arrangements which are commonly used by manufacturers or wholesalers in various industries in supplying goods to retailers.
4. At the end of this Ruling is a Table setting out the various consequences as regards assessable income, allowable deductions and trading stock on hand of both sellers and purchasers in relation to goods sold under conditional contracts and delivered on sale or return.

Conditional contract

5. In this Ruling, a 'conditional contract' refers to an arrangement under which goods are typically sold by a manufacturer or wholesaler (seller) to a retailer (purchaser) on the basis that the parties intend that property in the goods passes immediately to the purchaser on delivery of the goods, subject to a condition subsequent that the purchaser may return the goods to the seller at any, or within some specified, time. If the purchaser decides to return the goods to the seller, the conditional contract ceases, there is a repurchase by the seller and property in the goods reverts in the seller.

6. An invoice is rendered for the sale price of the goods on delivery to the purchaser, usually requiring payment within a specified period such as 30 or 60 days. It is often the case that the period for payment of the sale price by the purchaser is shorter than the period agreed for the return of the goods. This means that goods may be returned to the seller either before or after the purchaser has paid the sale price.

7. (a) When the goods are returned to the seller before the purchaser has paid the sale price, the purchaser is then not obligated to pay the sale price of the goods.
- (b) When the goods are returned after the purchaser has paid the sale price, the seller is then required under the contract to repay the sale price.

8. As a matter of trade practice, the seller usually raises a credit in favour of the purchaser for the sale price of the goods returned that is applied to future purchases of goods by the purchaser. Occasionally, the seller directly refunds the sale price to the purchaser.

Goods delivered on sale or return

9. 'Goods delivered on sale or return' refers to an arrangement whereby a seller delivers goods to a purchaser with the intention of giving the purchaser an option of buying the goods later on the terms set out in Sale of Goods legislation. Usually, the understanding is that property in the goods passes to the purchaser when the purchaser either:

- (a) signifies acceptance of the goods to the seller;
- (b) otherwise adopts the transaction, e.g., by onselling to a consumer; or
- (c) keeps the goods past a specified period agreed between the parties for returning the goods, or, if no period was fixed, past a reasonable time after delivery.

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10. No debt arises until one of the above events occurs. Property in the goods remains with the seller until the purchaser exercises the option to acquire the goods. If the goods are returned to the seller within the specified time referred to in paragraph 9(c) of this Ruling or, if no time was specified, within a reasonable time after delivery, property in the goods never vests in the purchaser.

Date of effect

11. 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).

Ruling

Derivation of income by seller - delivery of goods

12. We consider that income from the sale of goods under a conditional contract or resulting from a delivery of goods on sale or return, which is assessable to the seller on an accruals basis, is derived under subsection 25(1) of the Act when a sale of the goods takes place and a debt for the sale of those goods is created.

Conditional contracts

13. Under a conditional contract, we consider that a sale takes place and a debt is created when the goods are delivered by the seller to the purchaser once the seller has accepted the purchaser's order, as the seller is then entitled to demand payment of the sale price (see Example 1 in this Ruling).

Goods delivered on sale or return

14. When goods are delivered on sale or return, the seller is only entitled to demand payment from the purchaser when the goods are either adopted by the purchaser or are not returned within a specified or reasonable period. We consider that the sale price is derived as assessable income by the seller when either of those events occurs (see Example 2 in this Ruling).

Allowable deductions of purchaser - delivery of goods***Conditional contract***

15. When goods are delivered to a purchaser under a conditional contract, we consider that the purchaser then 'incurs' an outgoing in relation to the goods under subsection 51(1) of the Act, as the purchaser is then under a presently existing legal liability to pay the sale price within a specified period (see Example 1 in this Ruling).

Goods delivered on sale or return

16. When goods are delivered to a purchaser under a normal sale or return arrangement, we consider that the purchaser does not then 'incur' a loss or outgoing in relation to the goods under subsection 51(1), as the purchaser is not then under a presently existing legal liability to acquire the goods.

17. If the purchaser later exercises the option to acquire the goods, either by adopting the transaction or by not returning the goods within a specified or reasonable period, we consider that the purchaser then 'incurs' an outgoing under subsection 51(1) in acquiring the goods, as the purchaser is then under a presently existing legal liability to acquire the goods. Also, we consider that that outgoing is necessarily incurred in carrying on the purchaser's business as a retailer (see Example 2 in this Ruling).

Allowable deductions of seller - return of goods under conditional contract

18. As paragraph 13 above recognises, income is derived by the seller under a conditional contract at the time of sale. The debt payable by the purchaser is recognised by the seller as a revenue asset under accounts receivable and replaces the previous revenue asset of trading stock on hand. When goods are returned to the seller under a conditional contract before the purchaser has paid the sale price, the seller is deprived of the value of the account receivable.

19. We consider that the value lost is a revenue 'loss' necessarily incurred in carrying on the seller's business and is allowable as a deduction under subsection 51(1) when the goods are returned. The value lost represents a revenue loss incurred on the bringing to an end of the account receivable asset. The loss has been 'incurred', as the seller is under a presently existing legal liability under the contract to repurchase the goods, which has the effect of extinguishing the account receivable asset.

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20. When goods are returned after the purchaser has paid the sale price, the seller then has a presently existing legal liability under the contract to repay the sale price. We consider that the seller then necessarily incurs an outgoing in carrying on its business, which is allowable as a deduction under subsection 51(1). This is the case, regardless of whether the seller and the purchaser agree that the seller's liability to repay is satisfied by the seller raising a credit in favour of the purchaser for the sale price of the goods, that is applied to future purchases of goods by the purchaser, or whether the seller directly refunds the sale price to the purchaser.

21. Where the seller and the purchaser use the credit arrangement referred to in paragraphs 8 and 20 above, there is an issue as to the amount that is derived by the seller under subsection 25(1) (paragraph 13 above) and the outgoing that is incurred by the purchaser under subsection 51(1) (paragraph 19 above) in relation to the later sale. We consider that the conclusions in paragraph 20 above mean that the relevant amount is the normal sale price of the goods on that later sale, rather than the normal price reduced by the amount of the earlier credit (see Example 3 in this Ruling).

Derivation of income by purchaser - return of goods under conditional contract

22. As paragraph 15 above recognises, when goods are delivered to a purchaser under a conditional contract, we consider that the purchaser then 'incurs' an outgoing in relation to the goods under subsection 51(1). When goods are returned to the seller before the purchaser has paid the sale price, the purchaser is then released under the contract from its revenue liability. That release occurs in the ordinary course of business between the seller and the purchaser. We consider that the amount of the revenue liability released is an assessable gain derived by the purchaser under subsection 25(1) when the goods are returned.

23. When goods are returned to the seller after the purchaser has paid the sale price, the seller has a presently existing legal liability under the contract to repay the sale price. We consider that the purchaser derives an assessable gain under subsection 25(1) when the goods are returned, as the debt for the repayment of the sale price is created at this time in the ordinary course of business between the seller and the purchaser (see Example 3 in this Ruling).

Trading stock on hand***Conditional contracts***

24. When goods are delivered to a purchaser under a conditional contract, the purchaser obtains both property in, and physical possession of, the goods. We consider that goods so delivered and still in the possession of the purchaser at the end of a year of income are 'trading stock on hand' of the purchaser under section 28 of the Act. If the purchaser returns the goods to the seller before the end of the year of income, property in the goods reverts in the seller and we consider that the goods become 'trading stock on hand' of the seller again (see Example 1 in this Ruling).

Goods delivered on sale or return

25. When goods are delivered to a purchaser on sale or return, the purchaser obtains physical possession of, but not property in, the goods. Immediately after delivery to the purchaser, we consider that the goods, usually, are still 'trading stock on hand' of the seller under section 28, as the circumstances of a normal delivery on sale or return are not, in substance, the same as those that occurred in *FC of T v. Suttons Motors (Chullora) Wholesale Pty Ltd* (1985) 157 CLR 277; 85 ATC 4398; (1985) 16 ATR 567 (*Suttons Motors* case). If the purchaser later exercises the option to acquire the goods, either by adopting the transaction or by not returning the goods within a specified or reasonable period, we consider that the goods then become 'trading stock on hand' of the purchaser, as the purchaser then has both property in, and physical possession of, the goods.

26. However, if the circumstances of the delivery on sale or return to the purchaser are, in substance, the same as those that occurred in the *Suttons Motors* case, then we consider that the goods become 'trading stock on hand' of the purchaser at the time of delivery. If the goods are later returned to the seller, we consider that the goods become 'trading stock on hand' of the seller again (see Example 2 in this Ruling).

Explanations**General derivation principles - traders in goods**

27. It is an accepted principle of income tax law that the method under which a taxpayer accounts for its business or income producing activities for purposes of income tax must 'give a substantially correct reflex of the taxpayer's true income' (see Dixon J in *The Commissioner of Taxes (South Australia) v. The Executor Trustee and Agency*

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Company of South Australia Ltd (Carden's case) (1938) 63 CLR 108 at 154; (1938) 5 ATD 98 at 131).

28. Dixon J was demonstrating this principle in *Carden's case* when he made the point that the basis on which a trading concern ought to be taxed is on its earnings rather than on its receipts. He said ((1938) 63 CLR at 156; (1938) 5 ATD at 132):

'The basis of a trading account is stock on hand at the beginning and end of the period and sales and purchases. In such an account book debts represent what before sale was trading stock and it is almost inevitable that they should be taken into consideration upon an accrual and not a cash basis.'

29. This line of reasoning was used in *J Rowe & Son Pty Ltd v. FC of T* (1971) 124 CLR 421; 71 ATC 4157; (1971) 2 ATR 497 (*Rowe's case*) to conclude that the accruals basis is the appropriate method for determining the amount of income derived by a taxpayer carrying on a business of selling goods.

30. The dissenting reasons of Latham CJ in *Carden's case* were also considered to be of weight in concluding in *Rowe's case* that the income of a business trading in goods is derived when its stock is sold and a debt is created. The Chief Justice had said ((1938) 63 CLR at 125; (1938) 5 ATD at 110):

'...trade debts which have accrued due in the relevant year but which have not been paid must be included for the purpose of ascertaining whether or not the business has earned a profit for the year, just as stock in trade at the beginning and end of the year must be taken into account for the same purpose.'

31. This association between the existence of a debt and the sale of trading stock was further supported by von Doussa J (with whose reasons Jenkinson and Spender JJ agreed) in *Gasparin v. FC of T* 94 ATC 4280; (1994) 28 ATR 130 (*Gasparin's case*) where his Honour said (94 ATC at 4285; (1994) 28 ATR at 136) that it was:

'...correct to lay stress upon the prominence given in *Carden* and *Rowe* to the importance of there being a debt in conjunction with a sale of trading stock before income is derived.'

32. It is clear from this line of decisions that the sale price of trading stock is derived as income of the seller when the sale price becomes a debt that is presently owing to the seller.

33. It is also clear that the existence of a debt is not necessarily affected by an inability on the part of the seller to immediately recover the debt by action. Gummow J (with whose reasons Northrop and Drummond JJ agreed) made the point in *Barratt & Ors v. FC of T* 92 ATC 4275 at 4281; (1992) 23 ATR 339 at 346 (*Barratt's case*):

'No doubt a debt that is presently recoverable by action generally will be an amount "derived" in the relevant sense by the creditor.'

34. But this view was later qualified (92 ATC at 4283; (1992) 23 ATR at 348) when his Honour said:

'The distinction between the coming into existence of a debt and the operation of impediments upon the recovery of an existing debt is well established...'

and when he referred to the decision in *Re Pollack; ex parte DFC of T* 91 ATC 4925 at 4930, 4933, 4936; (1991) 103 ALR 133 at 140, 144, 147-149 as an example of the distinction.

35. The meaning of the word 'recoverable' was also the subject of some discussion in *Henderson v. FC of T* (1970) 119 CLR 612; 70 ATC 4016; (1970) 1 ATR 596 (*Henderson's case*). In respect of the relevant passages in that case, the view was expressed in *Barratt's case* (92 ATC at 4284; (1992) 23 ATR at 349):

'...*Henderson's Case* should not be understood as deciding that an amount cannot be derived unless presently recoverable by action.'

36. It is equally clear that a debt may be presently owing even though it may only become payable at some future date (see, for example, *Rowe's case*: (1971) 124 CLR at 450; 71 ATC at 4160; (1971) 2 ATR at 500 - the debt need not be payable in the income year in which the debt is created; and *Henderson's case*: (1970) 119 CLR at 651; 70 ATC at 4020; (1970) 1 ATR at 147 - fees are still relevantly recoverable even though time to pay is afforded).

Sale of goods and debt created

37. A sale occurs when property in the goods passes in exchange for an entitlement to payment of the sale price. Under the various State and Territory Sale of Goods Acts, the property in specific or ascertainable goods passes to a purchaser 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 (section 22 of the *Sale of Goods Act 1923* (NSW); section 22 of the *Goods Act 1958* (Vic); section 17 of the *Sale of Goods Act 1895* (SA); section 17 of the *Sale of Goods Act 1895* (WA); section 20 of the *Sale of Goods Act 1896* (Qld); section 22 of the *Sale of Goods Act 1896* (Tas); section 22 of the *Sale of Goods Act 1954* (ACT); section 22 of the *Sale of Goods Act 1972* (NT)).

38. If the parties' intention is not clear, that legislation also sets out some presumptions as to intention, that apply in certain circumstances.

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Paragraphs 5 and 9 of this Ruling set out when parties to both conditional contracts and to arrangements where goods are delivered on sale or return, respectively, intend property to pass in goods.

39. The sale proceeds on a sale of goods mature into a recoverable debt, i.e., a debt is created, when the sale proceeds are presently owing even though they may only become payable at some future date (see *Gasparin's* case (94 ATC at 4282; (1994) 28 ATR at 133) and *Ladenburg & Co v. Goodwin Ferreira & Co Ltd (in liq) and Garnett* [1912] 3 KB 275).

40. Sale proceeds may therefore be presently owing before the seller is entitled to sue for the proceeds. When the proceeds are so owing need not necessarily bear any relationship to the time property in the goods is transferred to the purchaser or to the time the goods are delivered to the purchaser. If no time is specified in the contract as to when the proceeds are presently owing, the previous course of dealings between the parties, in appropriate cases, may establish when they are presently owing.

41. If, when the proceeds are presently owing cannot be so implied, they are *prima facie* presently owing when the seller informs the purchaser that the seller is ready and willing to deliver possession of the goods. This is so because, under the Sale of Goods legislation (section 31 of the *Sale of Goods Act 1923* (NSW); section 35 of the *Goods Act 1958* (Vic); section 28 of the *Sale of Goods Act 1895* (SA); section 28 of the *Sale of Goods Act 1895* (WA); section 30 of the *Sale of Goods Act 1896* (Qld); section 33 of the *Sale of Goods Act 1896* (Tas); section 32 of the *Sale of Goods Act 1954* (ACT); section 31 of the *Sale of Goods Act 1972* (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.

42. The debt created must be recoverable, such that the seller is not obliged to take any further steps before becoming entitled to payment (*Farnsworth v. FC of T* (1948-49) 78 CLR 504; (1949) 9 ATD 33; *Henderson's* case; *FC of T v. Australian Gas Light Co* 83 ATC 4800; (1983-84) 15 ATR 105). The debt must not be subject to a contingency or condition. It must be presently owing, so that an immediate demand for payment may be made, although the debt is only payable in the future.

Conditional contract

43. As outlined in paragraphs 5 and 6 of this Ruling, a conditional contract provides for goods to be delivered on terms that the sale price

as invoiced is then presently owing, with payment required within a specified period and the purchaser entitled to a credit for unsold goods returned. In these circumstances, the intention of the parties is that property in the goods is to pass upon delivery, in exchange for the seller's entitlement to the sale price. A sale occurs at delivery. Any later return of goods to the seller is a repurchase, with property in those goods then reverting in the seller. Upon delivery, the seller has an unconditional entitlement to demand payment of the sale price.

44. That entitlement is not conditional on the goods being re-sold or not returned by the purchaser within the specified period. The purchaser's right to a credit for any goods returned is not a condition or contingency affecting the seller's entitlement to payment. It does not affect the creation of the debt for the sale price of those goods. The whole of the sale price, including any part attributable to goods which are later returned, is derived by the seller as assessable income at the time of delivery.

Goods delivered on sale or return

45. When goods are delivered on sale or return, the understanding is that the purchaser is not liable to pay the sale price as invoiced unless the goods are adopted by the purchaser in one of the ways outlined in paragraph 9 of this Ruling. In these circumstances, the purchaser has an option to purchase the goods delivered. Property in the goods passes to the purchaser on the exercise of the option. The seller's entitlement to payment of the sale price is contingent upon the option being exercised by the purchaser either onselling the goods or not returning them within the agreed or a reasonable period. As no debt for the sale price is created until then, that is when the sale price is derived as assessable income by the seller.

Allowable deductions of purchaser - delivery of goods

46. A purchaser who purchases goods from a seller as trading stock of the purchaser's business is entitled to allowable deductions under subsection 51(1) of the Act for the purchase price of the goods (*FC of T v. Raymor (NSW) Pty Ltd* 90 ATC 4461 at 4466; (1990) 21 ATR 458 at 462 (*Raymor's case*)).

47. Broadly speaking, expenditure on the purchase of trading stock qualifies as an allowable deduction under subsection 51(1) in the year of income in which it is 'incurred'.

48. The meaning of the word 'incurred' has been judicially interpreted on many occasions. For present purposes though, the following general propositions from the cases are relevant:

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- a liability can be presently existing in a year of income even though the liability remains unpaid at the close of that year of income (*FC of T v. James Flood Pty Ltd* (1953) 88 CLR 492 at 506; (1953) 10 ATD 240 at 244 (*James Flood*));
- for a liability to satisfy the word incurred, 'what is clearly necessary is that there should be a presently existing liability' (*Coles Myer Finance Ltd v. FC of T* (1993) 176 CLR 640; 93 ATC 4214; (1993) 25 ATR 95 (*Coles Myer Finance*); *Nilsen Development Laboratories Pty Ltd & Ors v. FC of T* (1981) 144 CLR 616 at 627; 81 ATC 4031 at 4037; (1981) 11 ATR 505 at 511); and
- an outgoing may be incurred even though it may later be defeated (*James Flood* (1953) 88 CLR 492 at 506; (1953) 10 ATD 240 at 244; *Commonwealth Aluminium Corporation Ltd v. FC of T* 77 ATC 4151 at 4160; (1977) 7 ATR 376 at 386).

Conditional contract

49. At the time of delivery, the purchaser is under a presently existing liability to pay the sale price within a specified period.

50. The essence of a conditional contract between the seller and the purchaser is a mutual agreement to transfer the goods from the seller to the purchaser for the sale price. The agreement is evidenced by an invoice for that sale price. There is nothing uncertain or contingent at the time of purchase about the sale price - it is the price at which the purchase has been mutually negotiated and it is both communicated and quantified. It is the obligation arising out of the contract of sale. Nothing further needs to be done to bring the debt into existence.

51. Although the opportunity for the purchaser to avail itself of returning the goods is provided in the contract of sale and therefore exists at the time of sale, the right to a refund of the sale price does not. The right to a refund of the sale price is only triggered by the return of goods within the specified or reasonable period. At the time of sale, the right to a refund of the sale price is a contingency only which may be satisfied at a later time by the occurrence of a specified event. The effect of the occurrence of that later event cannot operate to retrospectively alter the position which existed at the time of sale. The availability of a refund of the sale price provides no more than a circumstance in which the sale price otherwise contracted for can be varied. In these circumstances, the incurrance of the liability and the satisfaction of the liability are two separate albeit related events.

52. In other words, the purchaser has incurred the full sale price of the goods at the time of sale even though the purchaser may not ultimately have to pay for all of those goods because some of the goods may be later returned.

Goods delivered on sale or return

53. Paragraph 9 of Taxation Ruling IT 2472 states that, when goods are delivered on sale or return, and a sale to the deliveree is contemplated, it could well be that, as in the *Suttons Motors* case, the deliveree is effectively committed to the ultimate purchase of the goods at the time of delivery.

54. Paragraph 7 of Taxation Ruling IT 2325 says that motor vehicle dealers operating under floor plan arrangements similar to those in the *Sutton Motors* case are effectively committed to the later purchase of the vehicles at the time of delivery and, therefore, have incurred outgoings in acquiring the vehicles at that time.

55. The approach in IT 2325 was adopted to deal with an anomaly recognised as a result of the decision in the *Suttons Motors* case that the relevant vehicles were trading stock on hand of the dealer at the time of delivery. The anomaly was that, in the year the vehicles were delivered, there might not be a deduction available to the dealer under subsection 51(1) of the Act to offset the value of the vehicles on hand at the end of the year under section 28; and that in the following year when the vehicles were purchased, the dealer would effectively receive a double deduction under section 28 and subsection 51(1).

56. When both Rulings are read together, there is a suggestion that deliverees of trading stock on sale or return have incurred an outgoing under subsection 51(1) for the cost of acquiring the stock at the time of delivery. However, we consider that this is unlikely to be the case with a normal delivery of goods on sale or return, because, unlike the position in the *Suttons Motors* case, the nature of a normal delivery on sale or return is that the deliveree is not effectively committed to the ultimate purchase of the goods.

Allowable deductions of seller - return of goods under conditional contract

57. As recognised in paragraph 8 of this Ruling, conditional contracts provide for a sale of goods on credit terms. While the seller derives trading income on the sale at the time of delivery of the goods (see paragraph 12 of this Ruling), the seller's accounts recognise the provision of credit on the sale by the inclusion of an account receivable equal to the amount of the full sale price. The account

receivable, therefore, represents the credit sale made and is the asset that replaces the previous asset of trading stock. It is a revenue asset. We accept that the provision of sales on credit is an ordinary part of the seller's business.

58. When goods are returned to the seller before the purchaser has paid the sale price, the seller is contractually obliged to accept the goods and receives no payment under the contract. The purchaser's debt is extinguished and the seller is deprived of the value of the account receivable recognised in its accounts. In these circumstances, we believe that there is an issue about whether the seller has suffered a revenue 'loss' under subsection 51(1) on the failure to realise the value of the account receivable.

59. We consider that the loss is a revenue loss because the account receivable is a revenue asset of the seller, the amount of that receivable has previously been included in assessable income, and the practice of providing sales on credit is an ordinary part of the seller's business. The loss suffered by the seller is therefore an allowable deduction under subsection 51(1). This view is supported by Professor R W Parsons in his book *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting*, 1985, at paragraphs 6.308-6.321 where he describes the loss suffered as being 'a failure of a revenue asset to realise its cost'. He explains that the incurred cost of the receivable is the amount at which the receivable was brought to account as assessable income.

60. The view is also supported indirectly by the legislative provisions allowing losses suffered as a result of bad debts (section 63 of the Act) and embezzlement (section 71). Allowing deductions under subsection 51(1) for losses incurred by taxpayers in the business of money lending is also analogous where they do not realise the full extent of the credit facility provided. In that case, the money lent is trading stock of the moneylender.

Derivation of income by purchaser - return of goods under conditional contract

61. We have earlier concluded in paragraph 15 of this Ruling that a purchaser of goods under a conditional contract incurs an outgoing of an amount equal to the sale price of the goods under subsection 51(1) at the time of delivery of the goods. As the goods delivered can be returned by the purchaser either before or after the sale price has been paid to the seller, we believe that there is an issue about whether the purchaser derives an assessable gain under subsection 25(1) of an amount equal to the sale price of the goods returned.

62. When goods are returned before the purchaser has paid the sale price to the seller, the purchaser is released under the contract from its revenue liability. That release occurs in the ordinary course of business between the seller and the purchaser. We believe that a liability which is inherently releasable in the normal course of business is similar in nature to the variable liabilities discussed in *The Texas Company (Australasia) Ltd v. FC of T* (1940) 63 CLR 382; (1940) 5 ATD 298 and *International Nickel Australia Ltd v. FC of T* (1977) 137 CLR 347; 77 ATC 4383; (1977) 7 ATR 739.

63. Some early observations on variable liabilities were made by Dixon J in *The Texas Company (Australasia) Ltd* ((1940) 63 CLR at 465; (1940) 5 ATD at 354) when considering the treatment of an exchange loss under the accruals method:

'During any given accounting period the profit or loss made by the taxpayer's operations must be ascertained by a comparison between its position at the beginning and at the end, based upon estimates of value and upon the accrual of debits and credits. But discrepancies between the liabilities carried into the period and the cost of defraying them must come into the comparison as an actual reduction or increase of the profit or loss otherwise produced by the comparison, provided always that the liability is one belonging to an income account and that the loss ought not for other reasons to be referred to capital. For where liabilities are not fixed in their monetary expression, whether because of contingencies or because they are payable in foreign currency, a difference between the estimate and the actual payment must be born as a business expense, and where the continuous course of a business is divided for accounting purposes into closed periods it is a reduction of the net profit, which otherwise would be calculated for the period.'

64. In other words, the amount of a liability which is inherently 'variable' may not be finally determined until it is actually paid. But an uncertainty about the amount which may ultimately be paid in satisfaction of a variable liability in no way impinges on the deductibility of the variable liability at the time it was incurred.

65. We consider that the principles discussed in *International Nickel Australia Ltd* support the proposition that, in all cases involving a variable liability which has been allowed as a deduction, a reduction in the amount required to satisfy the liability gives rise to an assessable gain because the difference has the character of income under ordinary concepts.

66. Mason J said in *International Nickel Australia Ltd* ((1977) 137 CLR at 366; 77 ATC at 4394; (1977) 7 ATR at 751) that there is 'a general concept of income which includes within its embrace a

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reduction in the amount of an outgoing on revenue account'. In his Honour's opinion, the foreign exchange gain cases give expression to this general concept.

67. We consider that a reduction in the amount required to extinguish the incurred liability is therefore a gain assessable to the purchaser under subsection 25(1). We believe that the decisions in *The Texas Company (Australasia) Ltd* and in *International Nickel Australia Ltd* support the view that, for an accruals taxpayer, a release of a revenue obligation that occurs in the ordinary course of business gives rise to an assessable gain when the release occurs. This is the stance taken in paragraphs 22 and 23 of this Ruling.

68. When goods are returned to the seller after the purchaser has paid the sale price, the seller has a presently existing legal liability under the contract to repay the sale price. The income implications of a later refund of a liability on revenue account is dealt with in draft Taxation Determination TD 95/D15, where we take the view that such a refund will be included in the receiver's assessable income if the receipt constitutes income according to ordinary concepts. While the draft Taxation Determination only deals with the position of refunds actually received, we consider that the cases discussed therein support the view that, for an accruals taxpayer, an assessable gain is derived when the taxpayer obtains the right to the refund, rather than when the refund is actually received. On this basis, we believe that the gain derived would be income according to ordinary concepts, as it arises in the ordinary course of business between the seller and the purchaser.

Trading stock on hand

69. Generally, we consider that goods are 'trading stock on hand' of a person if that person is in a position to dispose of the goods (see paragraphs 3 to 5 of Taxation Ruling IT 2670). In most cases, a person has dispositive power over trading stock if the person has property in the stock, even though physical possession of the stock may not accompany the holding of property (see paragraph 6 of IT 2670). Where a person has physical possession of stock, but does not have property in the stock, we do not consider that the person has dispositive power over the stock unless the circumstances of the case are, in substance, the same as those that occurred in the *Suttons Motors* case (see paragraphs 12 and 13 of IT 2670). While we consider that the position for conditional contracts, as set out in paragraph 24 of this Ruling, is reasonably clear, the position for goods delivered on sale or return is less clear.

70. Taxation Ruling IT 2472, discussed earlier in paragraphs 53 to 56 of this Ruling, states that, generally, there can be situations where

goods delivered on sale or return can be trading stock on hand of the deliverer at the time of delivery. However, we believe that this general statement needs to be read subject to the later statements in IT 2670, referred to in paragraph 69 above.

71. When IT 2472 and IT 2670 are read together, we accept that a deliverer of goods on sale or return, who is effectively committed to the ultimate purchase of the goods at the time of delivery in the same way as in *Suttons Motors*, has dispositive power over the goods at the time of delivery. However, we believe that this is unlikely to be the case with a normal delivery on sale or return for the following reasons:

- (1) In a normal sale or return situation, the risk in relation to the goods does not pass to the deliverer on delivery. Only loss or damage to the goods caused by the deliverer is at the deliverer's risk (see *Poole v. Smith's Car Sales (Balham) Ltd* [1962] 2 All ER 482 at 489). The deliverer taxpayer in the *Suttons Motors* case assumed the risk over the vehicles from the time of delivery.
- (2) In the *Suttons Motors* case, the taxpayer and General Motors expected and intended for title to pass later to the taxpayer. In fact, no vehicle had ever been returned to GM. In a normal delivery on sale or return, there is no such expectation as a matter of law, and there would need to be evidence of significant previous dealings where there was an expectation that had virtually always been met.
- (3) The taxpayer in the *Suttons Motors* case was practically committed under the vehicle floor plan arrangement to the later purchase of the vehicles at the time of delivery. In a normal delivery on sale or return, the deliverer is not practically committed to later purchase the goods, and there would need to be evidence of such practical commitment.

Examples

Example 1- Conditional contracts

72. Hot Co is a publisher of books. A major part of its business is to sell its books to a large network of book retailers in the major metropolitan cities. The sale terms negotiated with Sweaty Palms Books Co are typical of the terms negotiated with most retailers. Whenever Sweaty Palms Books Co wants to order more books, it sends an order form to Hot Co. Hot Co then delivers the books ordered, accompanied by an invoice which requires payment of the sale price by Sweaty Palms Books Co within 30 days. The agreement

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between the parties is that property in the books passes to Sweaty Palms Books Co on delivery. However, as is often industry practice, the parties also have agreed that Sweaty Palms Books Co can return to Hot Co any or all of the books delivered at any time within 3 months of the date of delivery, provided that the books are in a substantially 'as new' condition.

73. Sweaty Palms Books Co sends an order form to Hot Co on 6 June 1995, requesting delivery of 1,000 books. Hot Co delivers those books to Sweaty Palms Books Co on 21 June 1995, accompanied by an invoice requiring payment of the sale price of \$10,000 by 21 July 1995. None of the 1,000 books is returned to Hot Co by 30 June 1995.

74. We consider that the sale price of the books is derived by Hot Co as assessable income under subsection 25(1) of the Act in the 1994-95 year of income. Also, we consider that the 1,000 books delivered to Sweaty Palms Books Co are not trading stock on hand of Hot Co under section 28 of the Act at the close of that year of income.

75. We consider that Sweaty Palms Books Co has incurred an outgoing of \$10,000 in the 1994-95 year of income under subsection 51(1) of the Act for the purchase of the books. Also, we consider that any books unsold to a retail customer at the end of that year of income are trading stock on hand of Sweaty Palms Books Co under section 28 of the Act.

Example 2 - Deliveries on sale or return

76. Rockbottom Co is a wholesaler of imported and locally manufactured compact discs. It distributes its compact discs to several large music retailing chains. For various commercial reasons, Rockbottom Co wishes to retain property in its compact discs after they have been distributed to the retailing chains. Under the terms of a distribution arrangement with one retailing chain, Dirty Dancing Ltd, Rockbottom Co delivers compact discs when Dirty Dancing Ltd sends it an order form. Rockbottom Co does not present an account for payment to Dirty Dancing Ltd at the time of delivery, but sends a price list which determines the sale price for any later sales of compact discs.

77. Rockbottom Co and Dirty Dancing Ltd agree that a sale of a compact disc to the latter occurs if Dirty Dancing Ltd:

- (a) sells the disc to a retail customer; or
- (b) retains the disc longer than 4 months after the time of delivery.

78. When a sale occurs, the sale price is then owing, but payable to Rockbottom Co within 7 days after the end of the month in which the sale occurs. The parties also have agreed that Dirty Dancing Ltd can return any or all of the compact discs to Rockbottom Co at any time within 4 months of the time of delivery.

79. Rockbottom Co delivers 5,000 compact discs to Dirty Dancing Ltd on 20 April 1995, in response to an order from Dirty Dancing Ltd. From that date until 30 June 1995, Dirty Dancing Ltd sells 2,000 compact discs to its retail customers and returns 200 compact discs to Rockbottom Co of recording artists who are not popular with its customers. Rockbottom Co's list price to Dirty Dancing Ltd for each of the compact discs which the latter sells to its customers is \$15. On average, Dirty Dancing Ltd returns about 15% of the compact discs delivered by Rockbottom Co.

80. We consider that Rockbottom Co derives \$30,000 (2,000 discs @ \$15 each) as assessable income under subsection 25(1) of the Act in the 1994-95 year of income on the sale of compact discs to Dirty Dancing Ltd. Also, we consider that 3,000 compact discs (2,800 still in the possession of Dirty Dancing Ltd plus the 200 returned to Rockbottom Co) are trading stock on hand of Rockbottom Co under section 28 at the close of that year of income.

81. We consider that Dirty Dancing Ltd has incurred an outgoing of \$30,000 in the 1994-95 year of income under subsection 51(1) for the purchase of 2,000 compact discs from Rockbottom Co. Also, we consider that none of the 2,800 compact discs still in Dirty Dancing Ltd's possession at the end of that year of income are its trading stock on hand under section 28.

Example 3 - Return of goods under conditional contract

82. MOS Productions Ltd is a manufacturer of pre-recorded video cassettes. It distributes its videos to the stores of several video hiring chains. The hiring outlets place the videos on their shelves, most for hire by customers, but with some available for retail purchase. MOS Productions Ltd has agreed with Hammer Videos Pty Ltd that it will send each of Hammer Videos Pty Ltd's stores a monthly delivery of the latest video releases.

83. As Hammer Videos Pty Ltd experiences wide variations in the hiring patterns of its customers, the parties have agreed that property in the videos passes to Hammer Videos Pty Ltd on delivery, with the proviso that Hammer Videos Pty Ltd can return to MOS Productions Ltd any or all of the videos delivered at any time within 2 months of the date of delivery, provided that the videos have not been used. An invoice accompanies delivery of the videos, requiring payment of the

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sale price by Hammer Videos Pty Ltd within 30 days. The parties also have agreed that, if Hammer Videos Pty Ltd returns any videos after it has paid for them, MOS Productions Ltd will credit the returns against future deliveries.

84. MOS Productions Ltd delivers 500 of the latest video releases to Hammer Videos Pty Ltd on 18 May 1995, accompanied by an invoice requiring payment of the sale price of \$5,000 by 17 June 1995. The \$5,000 debt payable by Hammer Videos Pty Ltd is recognised by MOS Productions Ltd in its accounts as an accounts receivable current asset. Hammer Videos Pty Ltd returns 100 of the videos to MOS Productions Ltd before 17 June 1995. On 17 June 1995, Hammer Videos Pty Ltd pays MOS Productions Ltd \$4,000 for the 400 videos still in its possession. Hammer Videos Pty Ltd returns a further 20 videos before 30 June 1995 and MOS Productions Ltd credits these returns against the delivery to Hammer Videos Pty Ltd in July 1995.

85. We consider that the \$5,000 sale price of the videos is derived by MOS Productions Ltd as assessable income under subsection 25(1) of the Act in the 1994-95 year of income. As Hammer Videos Pty Ltd returned 100 of the videos before payment of the sale price was required, MOS Productions Ltd was deprived of \$1,000 of the value of its account receivable. We consider that the value lost is a 'loss' necessarily incurred by MOS Productions Ltd in carrying on its business and is allowable as a deduction to MOS Productions Ltd under subsection 51(1) in the 1994-95 year of income. Also, we consider that, by 30 June 1995, MOS Productions Ltd has a presently existing liability to repay Hammer Videos Pty Ltd \$200 for the other 20 videos returned, which is allowable as a further deduction to MOS Productions Ltd under subsection 51(1) in the 1994-95 year of income. Of the 500 videos delivered, we consider that the 120 are trading stock on hand of MOS Productions Ltd under section 28 at the close of that year of income.

86. We consider that Hammer Videos Pty Ltd has incurred an outgoing of \$5,000 in the 1994-95 year of income under subsection 51(1) for the purchase of the videos. As Hammer Videos Pty Ltd returned 100 of the videos before payment of the sale price was required, Hammer Videos Pty Ltd was released from \$1,000 of its revenue liability. We consider that the amount of the liability released is an assessable gain derived by Hammer Videos Pty Ltd under subsection 25(1) in the 1994-95 year of income. Also, as MOS Productions Ltd has a presently existing liability by 30 June 1995 to repay Hammer Videos Pty Ltd \$200 for the other 20 videos returned, we consider that Hammer Videos Pty Ltd derives a further assessable gain under subsection 25(1) in the 1994-95 year of income. Of the 500 videos delivered, we consider that the 380 are trading stock on

hand of MOS Productions Ltd under section 28 at the close of that year of income.

Table

87. The following Table sets out the conclusions of this Ruling.

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	CONDITIONAL CONTRACT		SALE OR RETURN AGREEMENT	
	SELLER	PURCHASER	SELLER	PURCHASER
ASSESSABLE INCOME	<p>Assessable income is derived when:</p> <p>(a) the seller has accepted the purchaser's order; and</p> <p>(b) the goods are delivered by the seller to the purchaser.</p> <p>See Paragraphs 13, 43, 44 and Example 1.</p>	<p>Where the purchaser returns goods before payment, the purchaser is released from a revenue liability and therefore has made an assessable gain.</p> <p>See Paragraphs 20, 61 - 67 and Example 3.</p> <p>Where the purchaser returns goods after payment, a debt for the repayment of the sale price is created in the purchaser's favour which is an assessable gain.</p> <p>See Paragraphs 23 and 68 and Example 3.</p>	<p>Assessable income is derived by the seller when the purchaser exercises the option to acquire the goods. This occurs when either:</p> <p>(a) the goods are adopted by the purchaser (i.e., when they are on sold); or</p> <p>(b) the purchaser does not return the goods within a specified or reasonable period.</p> <p>See Paragraphs 14 and 45 and Example 2.</p>	<p>The purchaser does not derive an assessable gain when goods are returned as no outgoing was incurred when delivery was taken. This will not be the case where the facts are substantially the same as in <i>Sutton's Motors</i>.</p>
ALLOWABLE DEDUCTIONS	<p>Where goods are returned <i>before</i> payment, the seller is deprived of a revenue asset (the debt) and can deduct the value of the account receivable.</p> <p>See Paragraphs 18 - 19, 57 - 60 and Example 3.</p> <p>Where goods are returned <i>after</i> payment the seller is under a presently existing liability to repay the sale price and can deduct the amount owing.</p> <p>See Paragraphs 20 - 21 and Example 3.</p>	<p>On delivery of goods, the purchaser is under a presently existing liability to pay the sale price and therefore has incurred a deductible outgoing.</p> <p>See Paragraphs 15, and 49 - 52 and Example 1.</p>	<p>A debt does not arise in the seller's favour until the purchaser exercises the option to acquire the goods. (Delivery <i>per se</i> does not create a debt). It follows that when goods are returned, the seller is not deprived of any asset and has not incurred an outgoing under s51(1).</p>	<p>The purchaser does not incur an outgoing until the purchaser comes under a presently existing liability to acquire the goods. This does not occur until the purchaser exercises the option to acquire the goods.</p> <p>See Paragraphs 16, 17 and 53 - 56 and Example 2.</p>
TRADING STOCK ON HAND	<p>If and when the purchaser returns goods to the seller, property in the goods reverts and the goods again become part of the seller's trading stock on hand.</p> <p>See Paragraphs 24 and 69 and Example 1.</p>	<p>Goods purchased under a conditional contract become part of the trading stock on hand of the purchaser upon delivery. If the purchaser returns the goods, they once again become part of the <i>seller's</i> trading stock on hand.</p> <p>See Paragraphs 24 and 69 and Example 1.</p>	<p>Generally, property in goods will not pass on delivery. The goods will remain part of the trading stock on hand of the seller until the purchaser exercises the option to purchase.</p> <p>If the circumstances are substantially the same as in <i>Sutton's Motors</i>, the goods will become part of the purchaser's trading stock on hand on delivery. If the goods are returned they again become the seller's trading stock on hand.</p> <p>See Paragraphs 25 and 70 - 71 and Example 2.</p>	<p>In general, when a purchaser takes delivery of goods, they remain the trading stock on hand of the seller until the purchaser exercises the option to acquire the goods. Only if the facts are substantially similar to <i>Sutton's Motors</i> will the goods become the trading stock on hand of the purchasers on delivery.</p> <p>See Paragraphs 26 and 70 - 71 and Example 2.</p>

Your comments

88. If you wish to comment on this Draft Ruling please send your comments by: Friday 10 May 1996

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Commissioner of Taxation

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subject references

- accruals
- allowable deductions
- derivation of income
- income
- sale of goods
- trading stock
- trading stock on hand

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