

TR 97/15 - Income tax: conditional contracts: derivation of income; allowable deductions; trading stock on hand

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Taxation Ruling

Income tax: conditional contracts: derivation of income; allowable deductions; trading stock on hand

other Rulings on this topic

IT 2670

contents	para
What this Ruling is about	1
Definition	6
Date of effect	12
Ruling	13
Explanations	23
Examples	65
Table	75
Detailed contents list	76

*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.*

[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (<http://law.ato.gov.au>) to check its currency and to view the details of all changes.]

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;
 - (b) when a purchaser of goods under a conditional contract 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 any of the goods are returned by the purchaser and the seller repurchases the goods and either credits or refunds the sale price;
 - (d) whether a seller of goods under a conditional contract is entitled to a deduction under subsection 51(1) in respect of a provision for any of the goods which it anticipates will be returned;
 - (e) 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 any of the goods are later returned to the seller; and

- (f) whether goods which are delivered under a conditional contract 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 are trading stock, either in the hands of the seller or of the purchaser.
 3. This Ruling does not deal with cases where a purchaser takes delivery of goods under a contract of sale, but the passing of property is delayed by an express term of the contract, known as a 'Romalpa clause' (see *Aluminium Industrie Vaassen B V v. Romalpa Aluminium Ltd* [1976] 2 All ER 552), also known as a 'retention of title' or 'reservation of title' clause. The income tax implications of a 'Romalpa clause' in a contract for the sale of goods may be considered in a later Ruling.
 4. This Ruling also does not deal with cases where goods are delivered by a seller on a sale or return basis. 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 the Sale of Goods legislation. We believe that issues associated with a possible mismatch between when a deliverer of goods on a sale or return basis is entitled to a deduction under subsection 51(1) for an outgoing incurred in acquiring the goods and when the deliverer must recognise the goods as being trading stock on hand under section 28, require further consideration before they can be resolved. The issues also may be considered in a later Ruling.
 5. 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.

Definition

6. This Ruling uses the term '**conditional contract**'. This term refers to an arrangement which is commonly used by manufacturers or wholesalers (sellers) in various industries in supplying goods to retailers (purchasers).
7. A '**conditional contract**' refers to an arrangement under which goods are typically sold by a seller to a 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 any of the goods to the seller at any, or within some specified, time. If the purchaser decides to return any of the goods to the seller, the seller is obliged to repurchase those goods and property in the goods returned passes back to the seller.

8. 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 any of the goods. This means that goods may be returned to the seller either before or after the purchaser has paid the sale price.

9. (a) When any of the goods are returned to the seller before the purchaser has paid the sale price, the purchaser is then released from that part of its obligation to pay the sale price that relates to the goods returned.
- (b) When any of the goods are returned after the purchaser has paid the sale price, the seller is then required under the contract to repay that part of the sale price that relates to the goods returned.

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

Summary - characteristics of a conditional contract

11. Whether an arrangement is properly characterised as a conditional contract is determined objectively according to the terms of trade and any other relevant circumstances of the parties. The factors which tend to indicate that an arrangement is a conditional contract can be broadly summarised as follows:

- (a) The parties intend that, at the time of delivery, the purchaser does not have an option about whether or not to accept the goods which have been bargained for;
- (b) An invoice is presented to the purchaser on delivery, specifying a period for payment which is usually shorter than the period agreed for the return of any of the goods;
- (c) The contract of sale operates subject to a condition subsequent that, if any goods are not sold within a specified period of time, the purchaser has the option of

returning them to the seller, whereupon the seller is obliged to repurchase them;

- (d) If any of the goods are returned before they have been paid for, the purchaser is released from that part of its obligation to pay the sale price that relates to the goods returned; and
- (e) If any of the goods are returned after they have been paid for, the seller is required to repay the purchaser for the goods returned, but will usually credit the amount against future purchases.

Date of effect

12. 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

13. We consider that income from the sale of goods under a conditional contract, which is assessable to the seller on an accruals basis, is derived under subsection 25(1) of the Act when a debt for the sale of those goods is created under the contract of sale. We consider that a debt is created under the contract of sale when the goods are delivered by the seller to the purchaser once the seller has accepted the purchaser's order. The seller is then presently entitled to demand payment of the sale price within a specified period (see **Example 1** in this Ruling).

Allowable deductions of purchaser - delivery of goods

14. When goods are delivered to a purchaser under a conditional contract, we consider that the purchaser then 'incurs' an outgoing under subsection 51(1) of the Act in purchasing the goods, 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).

Allowable deductions of seller - return of goods

15. As paragraph 13 above recognises, income is derived by the seller under a conditional contract when the goods are delivered to the purchaser. The debt for the sale price, 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 any of the goods are returned to the seller before the purchaser has paid the sale price, the purchaser is then released from that part of the debt that relates to the goods returned and the seller is deprived of the equivalent value of the account receivable.

16. 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 loss has been 'incurred', as the seller is obliged under the contract to repurchase the goods and to release the purchaser from part of the sale price debt, which has the effect of extinguishing part of the account receivable asset.

17. When any of the 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 that part of the sale price that relates to the goods returned. 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 amount repayable, that is applied to future purchases of goods by the purchaser, or whether the seller directly refunds the relevant amount to the purchaser.

18. Where the seller and the purchaser use the credit arrangement referred to in paragraphs 10 and 17 above, we consider that the conclusions in paragraph 17 mean that the amount derived by the seller under subsection 25(1) (paragraph 13 above) and incurred by the purchaser under subsection 51(1) (paragraph 14 above) on the later sale is the normal sale price of the goods on that sale, rather than that price reduced by the amount of the earlier credit (see **Example 2** in this Ruling).

Allowable deductions of seller - provision for anticipated returns

19. Where goods are sold under a conditional contract, the seller may raise a provision, for accounting purposes, estimating the value of the goods which it anticipates will be returned after the end of the year of income. As set out in paragraphs 16 and 17 above, we consider that the seller does not incur a loss or outgoing under subsection 51(1), in relation to the return of any of the goods, until

those goods, in fact, are returned. It is not until then that the seller either is obliged to release the purchaser from the relevant part of the purchaser's debt or comes under a presently existing liability to repay the relevant part of the sale price of the goods. Accordingly, we consider that the seller is not entitled to a deduction under subsection 51(1) at the end of the year of income for a provision for the value of any goods which the seller anticipates will be returned in a later year of income (see **Example 2** in this Ruling).

Derivation of income by purchaser - return of goods

20. As paragraph 14 above recognises, when goods are delivered to a purchaser under a conditional contract, we consider that the purchaser then 'incurs' an outgoing under subsection 51(1) in purchasing the goods. When any of the goods are returned to the seller before the purchaser has paid the sale price, the purchaser is then released from part of the revenue liability. This 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 any of the goods are returned.

21. When any of the goods are returned to the seller after the purchaser has paid the sale price, the seller then has a presently existing legal liability under the contract to repay that part of the sale price that relates to the goods returned. We consider that the purchaser derives an assessable gain under subsection 25(1) when any of the goods are returned, as the debt for the repayment of part of the sale price is created at this time in the ordinary course of business between the seller and the purchaser (see **Example 2** in this Ruling).

Trading stock on hand

22. 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 any of the goods to the seller before the end of the year of income, property in, and physical possession of, the goods returned passes back to the seller and we consider that those goods become 'trading stock on hand' of the seller again (see **Examples 1 and 2** in this Ruling).

Explanations

General derivation principles - traders in goods

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

24. 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 (CLR at 156; 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.'

25. 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.

26. 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 a presently existing debt is created under a contract for the sale of goods (see Menzies J at CLR 450; ATC 4160; ATR 500 and Gibbs J at CLR 451-2; ATC 4160; ATR 501). The Chief Justice had said (CLR at 125; 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.'

27. 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 (ATC at 4285; 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.'

28. 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 presently existing debt.

29. It is also clear that the existence of a debt is not necessarily affected by an inability on the part of the seller to recover immediately 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.'

30. But this view was later qualified (ATC at 4283; 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.

31. 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* (ATC at 4284; ATR at 349):

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

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

Contract of sale of goods is made and debt created

33. A contract of sale of goods is made when the seller agrees to transfer the property in the goods to the purchaser for the sale price.

A contract of sale is an agreement to sell when the transfer of property in the goods takes place later or is subject to a condition later to be fulfilled. A sale occurs when property in the goods is transferred by the contract from the seller to the purchaser.

34. Under the various State and Territory Sale of Goods Acts, the property in specific or ascertainable goods passes to a purchaser at such times 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)).

35. The sale price of goods under a contract of sale is usually fixed by the contract or by the course of dealings between the parties. Unless the parties otherwise agree, delivery of the goods and payment of the sale price are concurrent conditions (see 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)).

36. Where property in goods has passed under a sale, the seller has a presently existing right to claim the sale price from the purchaser as a debt (see subsection 51(1) of the *Sale of Goods Act 1923* (NSW); subsection 55(1) of the *Goods Act 1958* (Vic); subsection 48(1) of the *Sale of Goods Act 1895* (SA); subsection 48(1) of the *Sale of Goods Act 1895* (WA); subsection 50(1) of the *Sale of Goods Act 1896* (Qld); subsection 53(1) of the *Sale of Goods Act 1896* (Tas); subsection 52(1) of the *Sale of Goods Act 1954* (ACT); subsection 50(1) of the *Sale of Goods Act 1972* (NT)). Under an agreement to sell, when a seller has a presently existing right to claim the sale price as a debt is determined by the terms of the contract and is not necessarily related either to delivery or to the passing of property (see subsection 51(2) of the *Sale of Goods Act 1923* (NSW); subsection 55(2) of the *Goods Act 1958* (Vic); subsection 48(2) of the *Sale of Goods Act 1895* (SA); subsection 48(2) of the *Sale of Goods Act 1895* (WA); subsection 50(2) of the *Sale of Goods Act 1896* (Qld); subsection 53(2) of the *Sale of Goods Act 1896* (Tas); subsection 52(2) of the *Sale of Goods Act 1954* (ACT); subsection 50(2) of the *Sale of Goods Act 1972* (NT), and *Minister for Supply and*

Development & Anor v. Servicemen's Co-operative Joinery Manufacturers Ltd & Anor (1951) 82 CLR 621).

37. Accordingly, we consider that the sale price of goods under a contract of sale becomes a presently existing debt when the contract of sale or the course of dealings between the parties so determines. There is no rule that the present existence of a debt for the sale price of goods only depends on either the delivery of the goods or the passing of property in the goods.

38. However, we accept that the debt created must be recoverable, in the sense that the seller is not obliged to take any further steps before becoming entitled to payment (*Farnsworth v. FC of T* (1949) 78 CLR 504; (1949) 9 ATD 33; *Henderson's case*; *FC of T v. Australian Gas Light Co* 83 ATC 4800; (1983) 15 ATR 105). The debt must not be subject to a contingency or condition before it can be said to be presently existing. A debt can be presently existing even if it is payable in the future.

Derivation of income by seller - delivery of goods

39. As outlined in paragraphs 7 and 8 of this Ruling, a conditional contract provides for goods to be delivered on terms that the payment of the sale price as invoiced is required within a specified period, with the purchaser usually entitled to a credit for unsold goods returned. In these circumstances, the intention of the parties under the contract of sale 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. A later return of any of the goods to the seller is a repurchase, with property in those goods then passing back to the seller. Upon delivery, the seller has an unconditional entitlement to demand payment of the sale price upon expiration of the specified period.

40. That entitlement is not conditional on any of the goods being on-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.

Allowable deductions of purchaser - delivery of goods

41. 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) 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*)).

42. 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'.

43. 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:

- a liability can be a presently existing liability in a year of income even though it is not payable until after the end of the 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* CLR at 506; ATD at 244; *Commonwealth Aluminium Corporation Ltd v. FC of T* 77 ATC 4151 at 4160; (1977) 7 ATR 376 at 386).

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

45. 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.

46. Although the opportunity for the purchaser to avail itself of returning any of the goods is provided for in the contract of sale and, therefore, exists at the time of sale, the right to a refund of any part of the sale price does not. The right to any refund is only triggered by the return of any of the goods within the specified or reasonable period. At the time of sale, the right to any refund 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 alter retrospectively the position which existed at the time of sale. The availability of any refund 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.

47. In other words, the purchaser has incurred a liability for the full sale price of all 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.

Allowable deductions of seller - return of goods

48. 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 13 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 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.

49. When any of the 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 less payment under the contract than originally agreed. The purchaser is released from part of its debt and the seller is deprived of part of the value of the account receivable recognised in its accounts. There is then 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.

50. We consider that the 'loss' is a revenue loss under subsection 51(1) 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 credit sales is an ordinary part of the seller's business. This view is supported by Professor RW Parsons in his book *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting*, 1985, at paragraphs 6.308 to 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 it was brought to account as assessable income.

51. The view is also supported by comments of David Hunt J in *Commercial Banking Co. of Sydney Ltd v. FCT* 83 ATC 4208 at 4214; (1983) 14 ATR 142 at 148 where his Honour recognised that

the non-receipt of a revenue item can be a 'loss' within the meaning of subsection 51(1).

Allowable deductions of seller - provision for anticipated returns

52. We concluded in paragraph 19 of this Ruling that a seller who sells goods under a conditional contract is not entitled to a deduction under subsection 51(1) at the end of a year of income for a provision for any of the goods which it anticipates will be returned after the end of the year. Even in situations where, based on past experience, the seller is able to predict, with a high degree of certainty, the value of any goods which will be returned in later years, we consider that no deduction is allowable for such a provision. We do not consider that the seller either is obliged to release the purchaser from the relevant part of the debt or comes under a presently existing liability to repay that part of the sale price that relates to the goods returned until such time as the goods are actually returned. Accordingly, the seller cannot be said to have incurred an outgoing until that time.

Alternative view

53. There is an alternative view that a seller of goods is entitled to a deduction under subsection 51(1) at the end of a year of income for the provision referred to in paragraph 52 above. This view suggests that a seller is under a presently existing and inevitable liability at the end of a year of income, capable of reasonable estimate at that time, to repay that part of the sale price that relates to those goods which are likely to be ultimately returned in a later year. The view is said to accord with usual accounting and commercial practice and to be supported by *C of IR v. Mitsubishi Motors New Zealand Ltd* 95 ATC 4711; (1995) 31 ATR 350 (*Mitsubishi Motors NZ Ltd*).

54. We consider that the relevant event which gives rise to a seller's presently existing liability to repay the purchaser for goods returned under a conditional contract is the return of those goods. We believe that the alternative view fails to recognise properly that this is what determines when the seller incurs an outgoing under subsection 51(1) in relation to the return of any goods. We also believe that the *Mitsubishi Motors NZ Ltd* decision does not support the alternative view. Rather, that decision and *RACV Insurance Pty Ltd v. FC of T* 74 ATC 4169; (1974) 4 ATR 610 and *ANZ Banking Group Ltd v. FC of T* 94 ATC 4026; (1994) 27 ATR 559 are based on the important fact that the events giving rise to the particular liabilities there in question had occurred before the end of the year of income. Some of the already occurred liabilities were not known to the taxpayers at that time, but were then capable of reasonable estimation. We do not

consider that this is the situation being referred to in the alternative view.

55. We also consider that the *Coles Myer Finance* case supports the view that commercial or accounting concepts are not critical in determining when an outgoing is incurred under subsection 51(1).

Derivation of income by purchaser - return of goods

56. We have earlier concluded in paragraph 14 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 any of 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 that part of the sale price that relates to the goods returned.

57. When any of the goods delivered are returned before the purchaser has paid the sale price to the seller, the purchaser is released from part of 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 (*International Nickel Australia Ltd*).

58. Some early observations on variable liabilities were made by Dixon J in *The Texas Company (Australasia) Ltd* (CLR at 465; 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 borne 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.'

59. 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.

60. 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.

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

62. 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 paragraph 20 of this Ruling.

63. When any of the goods delivered 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 that part of the sale price that relates to the goods returned. The income implications of a later refund of a liability on revenue account were considered in *HR Sinclair Pty Ltd v. FC of T* (1966) 114 CLR 537; (1966) 14 ATD 194 where the High Court took 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 *HR Sinclair Pty Ltd* case only deals with the position of refunds actually received, we consider that it supports 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

64. 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). We consider that the position for conditional contracts, as set out in paragraph 22 of this Ruling, is reasonably clear, as the purchaser obtains both physical possession of and property in the goods at the time of delivery.

Examples

Example 1- goods not returned

65. 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 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.

66. Sweaty Palms Books Co sends an order form to Hot Co on 6 June 1996, requesting delivery of 1,000 books. Hot Co delivers those books to Sweaty Palms Books Co on 21 June 1996, accompanied by an invoice requiring payment of the sale price of \$10,000 by 21 July 1996. None of the books are returned to Hot Co by 30 June 1996.

67. We consider that the sale price of the books is derived by Hot Co as assessable income under subsection 25(1) in the 1995-96 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 at the close of that year of income.

68. We consider that Sweaty Palms Books Co has incurred an outgoing of \$10,000 in the 1995-96 year of income under subsection 51(1) for the purchase of the books. Also, we consider that any of the

books which have not been sold to a retail customer as at the end of that year of income are trading stock on hand of Sweaty Palms Books Co under section 28.

Example 2 - return of goods

69. MOS Productions Ltd is a manufacturer and importer of pre-recorded video cassettes. One of its largest product lines is management training videos, which it distributes to a wide variety of organisations, including management training firms and specialist video retail outlets. Hammer Videos Pty Ltd is a company that sells a range of specialist video products, including management training videos, under mail order arrangements. MOS Productions Ltd has agreed with Hammer Videos Pty Ltd that it will send Hammer Videos Pty Ltd a monthly delivery of the latest management training video releases.

70. As Hammer Videos Pty Ltd experiences wide variations in the mail ordering 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 video packages have not been opened. An invoice accompanies delivery of the videos, requiring payment of the 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 and that, if it returns any videos before it has paid for them, Hammer Videos Pty Ltd is then released from that part of the sale price debts that relates to the videos returned.

71. MOS Productions Ltd delivers 500 of the latest management training video releases to Hammer Videos Pty Ltd on 18 May 1996, accompanied by an invoice requiring payment of the sale price of \$5,000 by 17 June 1996. 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 and by Hammer Videos Pty Ltd in its accounts as an accounts payable current liability. Hammer Videos Pty Ltd returns 100 of the videos to MOS Productions Ltd before 17 June 1996. On 17 June 1996, 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 1996 and MOS Productions Ltd credits these returns against the delivery to Hammer Videos Pty Ltd in July 1996.

72. The course of commercial dealings between MOS Productions Ltd and Hammer Videos Pty Ltd over the past few years suggests to

TR 97/15

MOS Productions Ltd at 30 June 1996 that it is likely that Hammer Videos Pty Ltd will return another 50 of the June delivery of videos in July 1996. As MOS Productions Ltd will be required to credit those returns against future deliveries, it considers it prudent at 30 June 1996 to raise a provision in its accounts to recognise the likely future liability of \$500.

73. We consider that the \$5,000 sale price of the videos is derived by MOS Productions Ltd as assessable income under subsection 25(1) in the 1995-96 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 part of the value of its account receivable and has incurred, in the 1995-96 year of income, a deductible loss under subsection 51(1) of \$1,000. Also, we consider that, by 30 June 1996, 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 1995-96 year of income. We consider that MOS Productions Ltd is not entitled to a deduction of \$500 under subsection 51(1) in the 1995-96 year of income for the provision for future returns. Of the 500 videos delivered, we consider that the 120 returned are trading stock on hand of MOS Productions Ltd under section 28 at the close of that year of income.

74. We consider that Hammer Videos Pty Ltd has incurred an outgoing of \$5,000 in the 1995-96 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, it was released from that part of its current liability that relates to the 100 videos returned. We consider that the \$1,000 part of the sale price is an assessable gain derived by Hammer Videos Pty Ltd under subsection 25(1) in the 1995-96 year of income. Also, as MOS Productions Ltd has a presently existing liability by 30 June 1996 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 of \$200 under subsection 25(1) in the 1995-96 year of income. Of the 500 videos delivered, we consider that the 380 still in the possession of Hammer Videos Pty Ltd at 30 June 1996 are its trading stock on hand under section 28 at the close of that year of income.

Table

75. The following Table sets out the conclusions of this Ruling:

	CONDITIONAL CONTRACT	
	SELLER	PURCHASER
ASSESSABLE INCOME	<p>Assessable income is derived when goods are delivered by the seller to the purchaser once the seller has accepted the purchaser's order.</p> <p>See Paragraphs 13, 39, 40 and Examples 1 and 2.</p>	<p>Where the purchaser returns any goods before payment, the purchaser is released from part of a revenue asset and, therefore, has made an assessable gain. See Paragraphs 20, 57 - 62 and Example 2.</p> <p>Where the purchaser returns any goods after payment, a debt for the repayment of part of the sale price is created in the purchaser's favour and an assessable gain. See Paragraphs 58 and 63 and Example 2.</p>
ALLOWABLE DEDUCTIONS	<p>Where any of the goods are returned <i>before</i> payment, the seller is deprived of part of a revenue asset (the debt) and has incurred a deductible loss for the relevant part of the value of the account receivable. See Paragraphs 15 - 16, 49 - 51 and Example 2.</p> <p>Where any of the goods are returned <i>after</i> payment, the seller is under a presently existing liability to repay part of the sale price and has incurred a deductible outgoing of the amount owing. See Paragraphs 17 - 18 and Example 2.</p> <p>The seller is not entitled to a deduction at the end of a year of income for a provision for the value of any goods which the seller anticipates will be returned in a later year of income. See paragraphs 19, 52 - 55 and Example 2.</p>	<p>On delivery of goods, the purchaser is under a presently existing liability for the sale price and, therefore, has incurred a deductible outgoing. See Paragraphs 14, and 44 - 47 and Examples 1 and 2.</p>
TRADING STOCK ON HAND	<p>If and when the purchaser returns any of the goods to the seller, property in the goods returned passes back to the seller and those goods again become part of the seller's trading stock on hand. See Paragraphs 22 and 64 and Examples 1 and 2.</p>	<p>Goods purchased under a conditional contract become part of the trading stock on hand of the purchaser upon payment. If the purchaser returns any of the goods they once again become part of the seller's trading stock on hand. See Paragraphs 22 and 64 and Examples 1 and 2.</p>

Detailed contents list

76. Below is a detailed contents list for this Ruling:

	Paragraph
What this Ruling is about	1
Class of person/arrangement	1
Definition	6
Summary - characteristics of a conditional contract	11
Date of effect	12
Ruling	13
Derivation of income by seller - delivery of goods	13
Allowable deductions of purchaser - delivery of goods	14
Allowable deductions of seller - return of goods	15
Allowable deductions of seller - provision for anticipated returns	19
Derivation of income by purchaser - return of goods	20
Trading stock on hand	22
Explanations	23
General derivation principles - traders in goods	23
<i>Contract of sale of goods is made and debt created</i>	33
Derivation of income by seller - delivery of goods	39
Allowable deductions of purchaser - delivery of goods	41
Allowable deductions of seller - return of goods	48
Allowable deductions of seller - provision for anticipated returns	52
<i>Alternative view</i>	53
Derivation of income by purchaser - return of goods	56
Trading stock on hand	64
Examples	65
Example 1- goods not returned	65
Example 2 - return of goods	69
Table	75
Detailed contents list	76

Commissioner of Taxation

25 June 1997

ISSN 1039 - 0731

ATO references

NO 96/10303-4

96/947-8

BO DT.DAN012

Previously released in draft form as
TR 96/D5

Price \$2.20

- SGA(Tas) 33
- SGA(Tas) 53(1)
- SGA(Tas) 53(2)
- SGA(ACT) 22
- SGA(ACT) 32
- SGA(ACT) 52(1)
- SGA(ACT) 52(2)
- SGA(NT) 22
- SGA(NT) 31
- SGA(NT) 50(1)
- SGA(NT) 50(2)

FOI index detail
reference number

I 1017289

subject references

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

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TR 97/15

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