Inland Revenue
Te Tari Taake

TRADING STOCK—TAX TREATMENT OF SALES AND AGREEMENTS TO SELL

PUBLIC RULING – BR Pub 04/06

Note (not part of ruling): This ruling is essentially the same as public ruling BR Pub 98/8 previously published in *Tax Information Bulletin* Vol 11, No 1 (January 1999). BR Pub 04/06 applies from 1 April 2003 to 31 March 2008. BR Pub 98/8 applied until the end of the 2002 income year.

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

This Ruling applies in respect of sections CD 3, FB 3, and OB 1 (definition of "trading stock") of the Income Tax Act 1994.

The Arrangement to which this Ruling applies

This Ruling applies to sales and dispositions of property (including contracts of sale of, and agreements to sell property) that is part of the trading stock of a business owned or carried on by the vendor.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- When stock is sold in the ordinary course of business, section CD 3 applies to include within gross income, amounts that are "derived" from that sale. For these purposes, such derivation occurs when the income is earned, being when a legally enforceable debt arises, or the right to be paid otherwise crystallises.

- If trading stock is sold outside the ordinary course of business, and/or together with any other assets of the business (whether the whole of the business or only a part of the business), section FB 3 applies to include within gross income for that year, all amounts received from the sale or disposition of that trading stock, or as the case may be, the price at which the Act deems the trading stock to have been realised. The date of sale or disposition differs, depending on whether a clearly expressed intention of

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the parties exists as to when property in the goods is to pass:

- If a clearly expressed intention of the parties as to the time of passing of property is evident from the terms of the contract, the conduct of the parties and the circumstances of the case, the date of sale or disposition will be the date the parties intended property in the goods to pass.

- If no clearly expressed intention as to the time of passing of property can be determined, the date of sale or disposition will be determined according to the appropriate statutory presumption contained in section 20 of the Sale of Goods Act 1908. In short:

  - If there is an unconditional contract for goods that are specific and in a deliverable state - the date the contract becomes unconditional.

  - If the vendor must do something to make such goods deliverable - the date such action is completed, and the buyer is notified.

  - If the vendor must weigh, measure, or test such goods in order to ascertain the selling price - the date such action is completed and the buyer is notified.

  - If goods are delivered to a buyer on "sale or return" or similar terms - the time at which the buyer signifies his or her approval or retains the goods without notifying rejection within an agreed or reasonable timeframe.

  - If unascertained or future goods are sold by description - when the goods are in a deliverable state and unconditionally appropriated to the contract by either party with the assent of the other.

The period for which this Ruling applies

This Ruling will apply from 1 April 2003 until 31 March 2008.

This Ruling is signed by me on the 27th day of May 2004.

Martin Smith
General Manager (Adjudication & Rulings)

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COMMENTARY ON PUBLIC RULING BR Pub 04/06

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in public ruling BR Pub 04/06.

Background

Where the trading stock of a business is being sold or disposed of, there has been some confusion about the point in time when the consideration is to be included in gross income. The confusion centres on whether the proceeds from the sale or disposal of trading stock should be included in gross income when delivery and payment occurs, or upon the sale and purchase agreement becoming unconditional. Inland Revenue became aware of this issue in the context of livestock sales, but the legal principles which determine this issue are applicable to trading stock per se and this public ruling applies to all trading stock.

Further confusion arose in terms of the question of whether section CD 3 or FB 3 applied to sales of trading stock made in the ordinary course of business.

In order to address the question, it has been necessary to look at the history of the sections, case law, and general principles of contract law as well as the effect of the Sale of Goods Act 1908 on contracts of sale of property.

Legislation

Part EE of the Act ensures that the value of trading stock at the beginning and end of the income year is taken into account when calculating the income of a business for tax purposes.

Section CD 3 states:

> The gross income of any person includes any amount derived from any business.

Section FB 3 states:

> Where in any income year the whole or any part of the assets of a business owned or carried on by any taxpayer is sold or otherwise disposed of (whether by way of exchange, or gift, or distribution in terms of a will or on an intestacy, or otherwise, and whether or not in the ordinary course of the business of the taxpayer or for the purpose of putting an end to that business or any part of it), and the assets sold or otherwise disposed of consist of or include any trading stock, the consideration received or receivable for the trading stock or, as the case may be, the price which under this Act the trading stock is deemed to have realised shall be taken into account in determining the taxpayer's gross income for that year, and the person acquiring the trading stock shall, for the purpose of calculating the person's taxable income for that year or for any subsequent income year, be deemed to have purchased it at the amount of that consideration or price. This section

> shall, with any necessary modifications, apply in any case where a share or interest in any trading stock is sold or otherwise disposed of by any taxpayer.

"Trading stock" is defined in section OB 1. It is defined slightly differently for the purposes of different sections of the Act, and over time. However, for the purposes of this discussion, it is sufficient to state that it includes anything produced or manufactured, anything held for sale or exchange, and livestock, but that it does not include land or financial arrangements to which the accrual rules apply.

Application of the legislation and case law

Which section applies?

Section CD 3 includes within gross income amounts derived from any business. If sales of trading stock occurred in the ordinary course of business, it would be expected that section CD 3 would apply to include such amounts within gross income. However, a broad and literal interpretation of section FB 3 would include amounts received from the sale of trading stock, whether or not the sale occurred in the ordinary course of business.

In order to resolve this apparent inconsistency, it is necessary to examine the history and interpretation of the sections and their overseas equivalents.

History of section FB 3

Section FB 3 was introduced in 1939 as part of a whole stock sub-code. It was acknowledged by the Hon. Mr Nash (recorded in NZ Parliamentary Debates Vol 256, 1939: 537) that the whole of the sub-code followed, to a large extent, the procedure adopted in Australia. However, the equivalent Australian subsection was explicit that it applied only to sales that were not made in the ordinary course of business. By expressly including the extra words in the New Zealand subsection, it must be presumed that Parliament had intended to address every possible existing and future mischief.

Prior to 1939, there was no stock sub-code in the Act, and the forerunner to section CD 3 operated to tax proceeds from the sale of trading stock.

The case of *Commissioner of Taxes v Doughty* [1926] NZLR 279 dealt with a single sale of stock (soft goods and drapery) when assets were moved from a partnership into a company vehicle. The Court of Appeal held that a profit derived from the sale of trading stock was assessable to tax, regardless of whether the stock was sold in the ordinary course of business or in a wind-up of the business, relying for support on *Anson v Commissioner of Taxes* [1922] NZLR 330. The Privy Council reversed the decision and said the sale was a result of a "slump market" and this was the sale of the whole business unit, which must be distinguished and certainly was not a sale made in the course of the taxpayer's business. Accordingly, the increase in the value of stock sold was not subject

to tax.

In 1924 (after the *Doughty case* had been brought to the Commissioner's attention, but before the Court of Appeal decision had been given), an amendment was made to (then) section 79(1)(a) of the Land and Income Tax Act 1923, which included within assessable income "all profits or gains derived from any business". The words added to the precursor to the current section CD 3 were "including any increase in the value of stock in hand at the time of transfer or sale of the business...". The additional sentence remained in place long after the enactment of the precursor to section FB 3 in 1939.

It appears that the words "whether or not in the ordinary course of business" included within section FB 3 had been included to prevent the section being circumvented, and to ensure that income from the sale of trading stock was always taxed, regardless of how it was effected. No consideration appears to have been given to the overlap between the application of the two sections.

Interpretation of section FB 3

In *Hansen and Ors v CIR* [1972] NZLR 193, it was held by the Court of Appeal that the precursor to section FB 4 (which deals with apportioning the consideration attributable to trading stock where such trading stock is sold together with other assets) could be used to permit the Commissioner to calculate the value of stock sold along with any other assets of the business, whether or not the overall purchase price agreed to by the parties specifically attributed an amount to the stock value. Haslam J discussed the history of the introduction of the "stock sub-code" and also subsequent changes to what are now sections FB 3 and FB 4. At page 205, he stated that:

> ... the Legislature intended that sections 98 to 102 inclusive should constitute a sub code for dealing with liability for taxation when trading stock (including livestock) is disposed of **with other assets**. (emphasis added).

Whilst the conclusion reached by Haslam J is practically workable, and would clarify the inter-relationship between sections CD 3 and FB 3, it does not necessarily reconcile with a literal interpretation of section FB 3. Even if the words "whether or not in the ordinary course of business" are read down, the section applies even where "... the whole or any part of the assets of the business ... [that are] sold or otherwise disposed of **consist of** or include trading stock". Therefore, the section will apply where the assets consist solely of trading stock, and there is no requirement that they be sold along with different assets.

What is required, however, is that the "whole or any part of the assets of a business" have been sold or disposed of. This appears to require more than merely the sale of individual items of trading stock in the ordinary course of business. It suggests that the section applies to larger transactions involving other assets, and/or multiple items of trading stock where the sale is more akin to the sale or disposal of **a group of business assets**. Whilst trading stock is technically an asset of the business, ordinary English language usage would not normally see the ordinary sale of an individual item of trading stock

described as a disposal of "part of the assets of a business".

In addition, it is relevant to note that the current structure of the Act clearly indicates that Part F deals with apportionment and re-characterisation of transactions. Such heading and structure of the Act imply that the section should not operate for sales of stock made in the ordinary course of business, but rather in more involved fact situations or where the Act treats transactions in a special way. Section AA 3(1) states that the meaning of a provision is to be found by reading the words in context and in light of the way that the Act is organised.

The better view is that section FB 3 does not apply to normal sales of trading stock made in the ordinary course of business, and applies only where the whole, or part, of the assets of a business are sold (whether the trading stock is sold along with other assets, or a group of trading stock items are the only items sold). It is inherent in such a view that the words "whether or not in the ordinary course of business" are included in the section to effect the intent of Parliament that the section should not be rendered inapplicable by means of a taxpayer seeking to argue that it is in the ordinary course of their business to effect such compound sales. Such a conclusion arguably requires a degree of reading down of those words, but results in a workable operation of the Act, and seems to reflect the Parliament's intention.

The result is that section CD 3 should apply to include within gross income all amounts derived from the sale of trading stock in the ordinary course of business, unless the trading stock is sold together with other items of trading stock, or assets of the business itself, in a way that suggests that (the whole or) a part of the business is being disposed of.

Section FB 3 will apply to include within gross income the value of trading stock sold or disposed of outside of the ordinary course of the business operations, or along with other assets of the business in such a way. Specific instances when section FB 3 will operate will include instances where large blocks of different types of stock are sold to a purchaser, a part of the business is sold, or the entire business is sold by the owner.

When determining the timing of gross income from stock sales, it will be important to ascertain which section applies. Section CD 3 includes proceeds from the sale of trading stock at the point in time they are "derived". Section FB 3 includes such proceeds at the point in time the trading stock is "sold or otherwise disposed of". This distinction can arguably be explained by the fact that ordinary derivation rules are to apply if usual trading stock sales occur in the ordinary course of a taxpayer's business. If the circumstances are otherwise, however, the Act may be seen to be "tightening" the test of the time of assessability.

When amounts from the sale of trading stock are "derived"

Section CD 3 operates to include within gross income amounts from the sale of trading

stock sold in the ordinary course of business. It is settled law that the timing of derivation and the method of accounting "should be that which is calculated to give a substantially correct reflex of the taxpayer's true income". (*C of T (SA) v The Executor Trustee and Agency Company of South Australia Limited* (1938) 63 CLR 108 (Carden's Case); *CIR v Philips (NV) Gloeilampenfabrieken* [1955] NZLR 868; *CIR v Farmers Trading Company Limited* (1982) 5 NZTC 61,200). It is also settled law that the word "derived" means more than merely received. It connotes the source or origin rather than the fund or place from which the income was taken, and means flowing, springing, or emanating from, or accruing (Philips). There are also established principles that in calculating income the method adopted should give the correct reflex of the taxpayer's income. For most business taxpayers the most appropriate method will be the accrual method of accounting. This means income could be derived even if payment has not yet been received, or a bill even rendered.

The general principle is that income is "derived" when it is earned, and has "come home" to the taxpayer. This **will be the point** at which a legally enforceable debt arises, or the right to be paid otherwise crystallises. In looking at whether a debt has been created, case law tends to show that this is in effect a two-stage enquiry. The first stage is to ascertain whether the parties have agreed, or a statute has imposed a requirement, as to when a debt is created. When this is clear, for the purposes of income tax, the income in question is considered to have been derived at that time. If there is no such agreement between the parties or statutory imposition, it is necessary to look at the general law to determine when a debt is created and thus when the income is derived.

The leading New Zealand case on derivation is *CIR v Farmers Trading Company Ltd* (1982) 5 NZTC 61,200. This case dealt with the question of when business profits were derived from trading stock sold when the company made "budget" sales (where the customer paid the purchase price over a period of five months by way of monthly instalments). It was held that such sales were fundamentally different to hire purchase sales because the title and the property passed with the possession of the goods, and the vendor could only sue for outstanding instalments. It was held that the business profits were derived when the stock was sold and a debt in favour of the vendor was created.

Richardson J (as he then was), cited *Carden's Case* with approval and, in particular, he restated that "the foundation of the accruals system is the view that the accounts should show at once the liabilities incurred and the revenue earned, independently of the date when payment is made or becomes due." At page 61,208, his Honour stated:

> The real question in this case is when trading profits are derived. Where a sale is made in the course of trade during the year any profit on sale must be recognised. That involves having regard to the debt arising in favour of the vendor and bringing it into account if it is practicable to do so.
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> ...
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> On sale of trading stock a debt arises in favour of the vendor. The stock leaves his account and prima facie the debt for which it was exchanged should be brought into account in its place. It is implicit in the legislation that trading debts cannot be ignored in the calculation of business profits

> and must be brought into account on a proper basis if that is feasible.
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> ...
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> [T]here may be no realistic way to reflect the debts in the trader's account. But in principle debts arising from sale of trading stock during an income year must be recognised in arriving at the profits derived in that year.

The Australian case of *J Rowe and Son Pty. Ltd v FCT* 71 ATC 4157 is consistent with the principles expressed in Farmers Trading. In this case the Full Court of the High Court considered when income was derived from the sale of stock by a retailer of household goods, in circumstances where the goods were purchased by customers but to be paid for by periodic instalments over an agreed term of 12 months or more. The sum to be paid was equal to the cash price plus 11% interest per annum, and the taxpayer included in assessable income returned for each year only the instalments received or receivable in that year. The Court held that for tax purposes a trader's income is derived when it is earned, even though not received. The "profit emerging" method was considered inappropriate and the full cash price of the stock was considered earned and therefore derived during the year of the sale contract. Gibbs J stated at page 4,160:

> I agree that for taxation, as well as for business purposes, income of a trading business is derived when it is earned and the receipt of what is earned is not necessary to bring the proceeds of sale into account ... The method adopted should be that which is 'calculated to give a substantially correct reflex of the taxpayer's true income: Carden's case.'

In delivering the majority judgment, Menzies J stated, at pages 4,158 and 4,159:

> It is implicit in the foregoing provisions that the proceeds of any sale of stock in the ordinary course of business will be brought into account in the year in which it is sold ... In a system of annual accounting, ordinary business considerations would indicate that what becomes owing to a company for trading stock sold during a year should, in some way, be brought into account to balance the reduction of trading stock which the transaction affects. Any other method of accounting would lead to a misrepresentation of the trader's financial position.
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> ...
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> Acceptance of the taxpayer's contention [that income was derived only when instalments were due and receivable] would, of course, largely destroy the accepted basis for the taxation of most trading and business concerns.

The general principle that income is derived when it is earned, and that such time will be when there is an entitlement to payment or a legally enforceable debt, was also applied in *Hawkes Bay Power Distribution Ltd v CIR* (1999) 19 NZTC 15,226. In that case Richardson P delivered the judgment of the Court of Appeal which essentially agreed with Goddard J's conclusion in the High Court that the taxpayer's income was derived at the contemporaneous point in time the electricity was supplied by the taxpayer and consumed by its customers. The Court of Appeal considered that the income earning process was complete on supply and sale of the electricity to the consumer.

Sales of land

Section OB 1 provides that generally, land is not considered to be trading stock, however the definition also states that in limited circumstances (sections EE 19, FF 13, GD 1 and GD 2 when any amount derived from the sale or disposal would be gross income to which sections CD 1 applies) land may be trading stock. If a particular sale of land was within these provisions it would be considered for those purposes to be trading stock and therefore the ruling it may be applicable if it was unclear from the contract when the sale or disposal was to take place.

Although land is not generally trading stock as defined in section OB 1 (or subject to the Sale of Goods Act), it is worth noting that the same general principles in relation to derivation apply to the sale of land, or where the contract is otherwise an executory contract. However, although the applicable derivation principles are the same for land as for other property, the exact timing of when income is earned and a legally enforceable debt arises may be different. The difference will arise where the contract has an executory nature, and the vendor is not legally entitled to sue for the purchase price until after settlement. For a more in-depth discussion of the principles of derivation in relation to "sales of land by business taxpayers who provide vendor finance" and the case of *Gasparin v FCT* (1994) 94 ATC 4,280, refer to the QWBA of this title which was published in the *Tax Information Bulletin* Vol 16, No 5 (June 2004).

The case of *Gasparin v FCT* (1994) 94 ATC 4,280 specifically addressed the question of when income from the sale of the land was "derived". In delivering the judgment of the Full Federal Court, von Doussa J concluded that ordinary derivation principles applied, but on the facts of the case, a legally enforceable debt did not arise until the date of settlement and conveyance (when the executory contract was executed). Before this date, the vendor merely had a right to sue for specific performance of the contract, but not for the debt itself.

His Honour stated that there was no difference between the sale of land or other executory contracts, and the sale of retail goods, in terms of the principles that apply to the question of derivation for tax purposes. He was satisfied that income is derived when it is earned and a debt is due, according to ordinary principles. The difference in the timing of derivation that occurred for the land in that case, compared to a sale of other goods, was caused by the fact that title did not pass to the purchaser, and there was no legal right for the vendor to sue for a debt prior to the settlement/conveyance. Because that was the only point at which a legal debt arose, derivation did not occur until that time.

Von Doussa J also pointed out that his conclusions were consistent with judicial "sign posts" on derivation principles, such as *Barratt v FCT* (1992) 92 ATC 4,275, *Farnsworth v FCT* (1949) 78 CLR 504, *Henderson v FCT* (1970) 70 ATC 4,016 and *FCT v Australian Gas Light Co* (1983) 83 ATC 4,800.

It must be remembered however, that the facts of each case need to be examined, rather than assuming all executory contracts will automatically result in derivation occurring on settlement. If the facts of a case clearly show an earlier debt (rather than being able to sue for specific performance) and/or passing of property, the time of derivation will be earlier.

When stock is "sold or otherwise disposed of"

The question of when stock is "sold or otherwise disposed of" becomes important when considering section FB 3, where stock is sold along with other assets of the business. This is a different question to when income is "derived".

Sale of Goods Act 1908

The phrase "sold or otherwise disposed of", as used in section FB 3, is not specifically defined for the purposes of the Income Tax Act 1994, but some guidance is provided by case law and the Sale of Goods Act 1908 ("SGA"), which indicate that a sale of goods occurs when property in those goods passes to the purchaser.

Although section 2 of the SGA states that " 'contract of sale' includes an agreement to sell as well as a sale", section 3 of that Act recognises a distinction between a "contract of sale of goods" and an "agreement to sell". There is a "contract of sale of goods" when a seller agrees to transfer property in the goods for a consideration called the "price". A sale is effected once the property in the goods is transferred from the seller to the buyer. In contrast, there is an "agreement to sell" when the transfer of property in the goods is to take place either at some future time or is subject to the fulfilment of some condition. A sale is effected either when the time elapses or the conditions are fulfilled.

When property passes depends on whether the goods are specific or unascertained. The term "unascertained goods" is not defined in the SGA, but Butterworths Commercial Law in New Zealand (Borrowdale 3 ed, Butterworths) states at Chapter 12.3:

> ... it is clear that unascertained goods are goods which are not identified and agreed on at all. Unascertained goods become ascertained goods once they are identified and agreed on in accordance with the contract.

Under section 18 of the SGA, no property is transferred in unascertained goods unless and until the **goods** are ascertained. Goods may be unascertained because they are generic goods sold by description (*Re Gold Corp Exchange Ltd* [1994] 3 NZLR 385) or because they are not yet severed from part of a larger bulk (Re Wait [1927] 1 Ch 606).

Specific goods are defined in section 2(1) of the SGA as "goods identified and agreed on at the time a contract of sale is made".

(a) *The timing when the parties agree*

Section 19(1) and (2) of the SGA provide that property in specific goods is transferred from the seller to the buyer at such time as the parties to the contract intended to be transferred, and that when ascertaining the intention of the parties regard should be had to the terms of the contract, the conduct of the parties, and the circumstances of the case. Accordingly, any explicit intention of the parties as to when property in the goods passes will be recognised as the date the sale occurs.

(b) *The timing when the parties' agreement is not evident*

However, in situations where the parties have either not formed an intention as to when property shall pass, or have not clearly expressed their intention, section 20 of the SGA sets out five rules for determining the moment when the property in the goods will be deemed to have passed from a seller to the buyer. Which rule applies depends upon such factors as whether the contract is for the sale of specific or unascertained goods, or the seller is bound to do something to the goods. For the purposes of this discussion, rule 1 in section 20 is considered the most relevant (and common). Section 20 states:

> Unless a different intention appears, the following are rules for ascertaining the intention of the parties as to the time at which the property in the goods is to pass to the buyer:
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> Rule 1. Where there is an unconditional contract for the sale of specific goods, in a deliverable state, the property in the goods passes to the buyer when the contract is made, and it is immaterial whether the time of payment or the time of delivery, or both, is postponed.
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> Rule 2. Where there is a contract for the sale of specific goods, and the seller is bound to do something to the goods for the purpose of putting them into a deliverable state, the property does not pass until such thing is done, and the buyer has notice thereof.
>
> Rule 3. Where there is a contract for the sale of specific goods in a deliverable state, but the seller is bound to weigh, measure, test, or do some other act or thing with reference to the goods for the purpose of ascertaining the price, the property does not pass until such act or thing is done, and the buyer has notice thereof.
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> Rule 4. Where goods are delivered to the buyer on approval, or "on sale or return" or other similar terms, the property therein passes to the buyer –
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> (a) When he signifies his approval or acceptance to the seller, or does any other act adopting the transaction:
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> (b) If he does not signify his approval or acceptance to the seller, but retains the goods without giving notice of rejection then, if a time has been fixed for the return of the goods, on the expiration of such time, and if no time has been fixed, on the expiration of a reasonable time. What is a reasonable time is a question of fact.
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> Rule 5. (1) Where there is a contract for the sale of unascertained or future goods by description, and goods of that description and in a deliverable state are unconditionally appropriated to the contract, either by the seller with the assent of the buyer or by the buyer with the assent of the seller, the property in the goods thereupon passes to the buyer. Such assent may be expressed or implied, and may be given either before or after the appropriation is made.
>
> (2) Where, in pursuance of the contract, the seller delivers the goods to the buyer, or to a carrier or other bailee (whether named by the buyer or not) for the purpose of transmission to the buyer, and does not reserve the right of disposal, he is deemed to have unconditionally appropriated the goods to the contract.

Date of sale for section FB 3

The general principle is therefore that the date of sale occurs when property in the goods

passes. When an express intention of the parties can be ascertained as to when property passes, that will be the date of sale. If no intention is expressed or can be ascertained, the date of sale will be ascertained according to the statutory rules/presumptions contained in section 20 of the SGA, (commonly the date an unconditional contract exists). This general approach has also been upheld in tax cases.

Case law

While there is no New Zealand case law on the effect of the SGA on section FB 3, the Australian Commonwealth Taxation Board of Review referred to the Australian Sale of Goods Act when deciding in *Case 18* (1946) 12 CTBR 120 that property had been disposed of by way of sale when the contract became unconditional. The issue in Case 18 was whether the taxpayer's property had for the purposes of section 36(1) of the Australian Income Tax Assessment Act 1936 been "disposed of by sale or otherwise howsoever...". The Chairman of the Board of Review noted in relation to the sale of goods at page 125:

> The ownership of the goods will be transferred by the contract itself (in which case, the contract is the sale) if the parties express that intention but where the parties form no intention as to the time when the property is to pass, or fail to express their intention, the time when the property passes is determined by certain statutory presumptions. Of these presumptions the only one which deems the property in the goods to pass when the contract is made arises where there is an unconditional contract for the sale of specific goods in a deliverable state. In view of these principles (... and most which are embodied in the Sale of Goods Act) it appears to me to be quite clear that the property in the goods which were included in the assets which where the subject of the contract under consideration did not pass from the taxpayer to the purchasers until 25 August 1943, when the last of the three necessary consents was given.

The similarity of the SGA legislation in Australia and New Zealand (reflecting their common UK origins), coupled with the fact that the trading stock provisions in the Australian Income Tax Assessment Act 1936 are very similar both in their treatment of trading stock and the wording in section 36(1), are factors which make Case 18 relevant, and good law in New Zealand on this particular issue.

A similar result was arrived at in the context of when a sale of land had taken place, in *Mills v CIR* (1985) 7 NZTC 5,025 when the High Court held that for a sale of land to take place there must be an unconditional agreement for the sale of the land. This principle was also upheld in *Case K60* (1988) 10 NZTC 487.

In *Hansen v CIR* [1972] NZLR 193, the Court considered the precursor to section FB 4 and whether the Commissioner could calculate the value of stock sold along with the other assets of the business, regardless of an overall price having been agreed to by the parties in relation to the stock value. Of interest to this discussion, the Court gave effect to the intentions of the parties in relation to when property in the livestock passed. In that case, prior to settlement the purchaser was not permitted to shear the sheep which were the stock of the business, and as such there was an implied lack of property in the sheep until that date. The Court concluded that settlement date was the appropriate date to value

the sheep for the purposes of calculating their sale price, as that was clearly the date the parties intended property in the sheep to pass to the purchaser, and so that was the date on which they were sold.

Whilst the SGA determines when there is a sale of **personal** property in New Zealand, the same principles have been applied to real property in the above cases. Accordingly, for the purposes of section FB 3 trading stock is "sold or otherwise disposed of" when property in the goods passes. This will occur when the parties intend property to pass, where an express intention can be ascertained. If no intention can be ascertained, the statutory presumptions contained in Rules 1 to 5 of section 20 of the Sale of Goods Act will determine when property passes, and therefore when a sale or other disposition occurs.

When a contract is unconditional

As Rule 1 will often be relevant, it is important to understand when a contract becomes unconditional.

An unconditional contract is a contract that is not subject to a condition precedent. The contract may still be subject to a condition subsequent, but this will not prevent the contract from being unconditional. "Condition precedent" is a legal term for those conditions in a contract which suspend a contract until a specified event has occurred. A common example of a condition precedent is a contract that is subject to finance. In other words, the contract will be suspended until the buyer has advised the seller that he or she has obtained the necessary finance.

A "condition precedent" is to be contrasted with a "condition subsequent", which is a condition which can either bring a binding contract to an end (either totally or only partially) or entitle a party to damages. A common example of a condition subsequent is a contract that entitles a buyer to return dairy cattle if they prove not to be eczema free or sound on delivery. An unconditional contract can still be subject to conditions subsequent.

The Courts of New Zealand have sought to establish the intentions of the parties to the contract to ascertain whether it was intended that the condition be one which needed to occur prior to the contract coming into existence (a condition precedent) or whether the condition was one which was to occur after the contract came into existence i.e. (a condition subsequent). The Court of Appeal in *Hunt v Wilson* [1978] 2 NZLR 261 was reluctant to simply rely on the labels "conditions precedent" and "condition subsequent", and instead considered that it was necessary to look at the parties to the contract to ascertain whether or not a contract has come into existence.

The accrual rules

The ruling does not consider any potential operation of the accrual rules where the

arrangement attracts the operation of those provisions.

This may occur when settlement is scheduled to take place more than 63 days from the date an agreement for sale and purchase is entered into, or if there is a trade credit debt permitting payment more than 63 days after the supply of the trading stock or date of a periodic invoice. In either case the arrangement will not be a "excepted financial arrangement".

If the accrual rules do apply, the approach in the ruling will apply in relation to the consideration that is effectively attributed by the Act to the property sold (as distinct from any deemed financial arrangement income or expenditure that arises by virtue of section EH 1 (Division One) or sections EH 33-36 (Division Two)).

Examples

Example 1

A customer enters a sporting goods store and purchases a tennis racquet, which comes with a 30 day money-back guarantee if not completely satisfied. The customer pays by cheque.

The income from the sale is derived by the store in terms of section CD 3 on the day the customer enters the store and purchases the tennis racquet. The tennis racquet is sold in the ordinary course of business, and at that point the income has been earned (and therefore derived), regardless of whether the cheque is subsequently dishonoured or the customer returns at a later date seeking a refund under the guarantee.

Example 2

A large appliance store and a purchaser sign a sale and purchase agreement for the sale of a refrigerator on the 12th March, which permits the customer to take delivery of the refrigerator that day, on payment of a 25% deposit. The contract provides that risk passes to the purchaser upon delivery of the refrigerator, but property does not pass until payment of the balance of the purchase price, which occurs one month later.

The income from the sale is derived in terms of section CD 3 on 12 March, as it is a sale of trading stock in the ordinary course of business, and on that day the income has been earned and a legally enforceable debt has arisen when the purchaser took delivery of the refrigerator.

Example 3

On 20 May, Vendor and Purchaser enter into an agreement for the sale and purchase of a herd of dairy cattle, and a deposit is paid. The agreement states that the balance of the

purchase price shall be paid on the day of delivery/settlement, and that property in the cattle passes on that day. The agreement is subject to the buyer confirming finance on or before 15 June.

The vendor is entitled to continue milking the herd (and retain any proceeds) until the stock is delivered. Both parties have a 31 May balance date.

The vendor culls 20% of her herd each year, so it is within the vendor's usual business to sell individual herds of cattle, and she is left with other herds to continue her business operations.

The purchaser confirms on 3 June that finance has been arranged. The contract becomes unconditional on 3 June. Payment is made and possession given and taken on 20 June.

Section CD 3 applies, as the sale is made in the ordinary course of business, and for the purposes of section CD 3 the income is derived on 20 June. That is when the income is earned, the contract is no longer executory, and a legally enforceable debt first arises.

This example illustrates the difference that is possible between the date of "derivation" and the date of "sale". If this had not been a sale made in the ordinary course of business, the fact that the agreement explicitly stated that property in the goods passes on settlement would have resulted in the same date of 20 June being the date of sale. However, if there had been no express intention of the parties evident as to when property in the cattle passed (either by virtue of the agreement itself or the circumstances of the case/conduct of the parties), the date of sale for the purposes of section FB 3 would have been 3 June, when the contract became unconditional.

(Unless Rule 4 or 5 of the Sale of Goods Act 1908 applied, due to a delivery on an approval basis, or the goods being unascertained and sold by description.)

Example 4

Vendor and Purchaser enter into an agreement for the sale and purchase of a plot of land and a herd of cattle on 15 April. The sale is subject to the buyer confirming finance on or before 20 May, with payment of the balance and possession being given on 19 June. Finance is confirmed on 20 May. The contract became unconditional on 20 May and payment is made and possession given and taken on 19 June. Both parties have a 31 May balance date. **There is no clear indication in the contract as to when property in the goods passes**.

For the purposes of section FB 3, the cattle were sold on 20 May, when the contract became unconditional, as there is no express intention of the parties as to when property in the goods is to pass, and Rule 1 of the Sale of Goods Act applies.

If the contract also stated that the cattle could be returned within 7 days if they were not

eczema-free on delivery, and the purchaser signified later that same day that the cattle were pronounced eczema-free and would not be returned, the date of sale will differ. The existence of such a condition in the contract is a condition subsequent (rather than a condition precedent), and accordingly the contract is not **conditional** upon the cattle being eczema-free, and there is no alteration of the date the contract became unconditional. However, it does mean that the cattle are delivered on "sale or return" (or similar) terms, as envisaged by Rule 4 of the Sale of Goods Act. This means the date of sale will be 19 June, when the purchaser signifies his approval and retention of the cattle.

If the parties had included an explicit clause in the original contract described above (without the "sale or return" terms) that delivery did not occur and property did not pass until payment was made in full, this intent would be recognised, and the sale would be considered to have been made, for the purposes of section FB 3, on 19 June.

Example 5

A customer orders a photocopier from his regular office equipment supplier, by way of mail order from a catalogue description. The order is posted on 12 September, and received by the vendor on 15 September. A photocopier is taken from the stock warehouse and shipped on 20 September, with delivery to the customer taking place the next day. The standard terms of sale are that goods are sent FOB (which, for the purposes of this example, are taken to mean that risk, title, and property in the goods pass when the goods are put onto the delivery truck), and the photocopier is delivered with an invoice indicating the terms of payment.

As this sale is made in the ordinary course of operating an office equipment business, the gross income from the sale is subject to tax under section CD 3. The income is "derived" on 20 September, when the stock is shipped, and it can be said that the income has been earned and a debt become due and enforceable under the terms of the sale.

If the sale contract conditions were that the goods are delivered COD (and clearly indicated that risk, title, and property in the goods did not pass until delivery), the income would be "derived" on 21 September. In such a situation, no debt is enforceable until delivery occurs.

If the order was for a bulk supply of photocopiers and facsimile machines sold by a vendor who was ceasing trade in electrical office appliances, section FB 3 would apply and the time of "sale" is what is relevant. Such an order is for generic items which are unascertained goods at the time the order is made. The goods do not become specific goods until such time as the particular photocopiers are identified, and it is possible to say that such items are the customer's. In the absence of any differing clear contractual intention, this would occur on 20 September, which is when the items are appropriated to the contract, property passes and the sale occurs.