

# ***TR 98/8 - Income tax: whether materials and spare parts held by a taxpayer supplying services are trading stock***

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## Taxation Ruling

# Income tax: whether materials and spare parts held by a taxpayer supplying services are trading stock

### other Rulings on this topic

IT 333; TR 93/20; TR 98/7

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### *Preamble*

*The number, subject heading, and the **Ruling and Date of effect** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner. The remainder of the document is administratively binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

## What this Ruling is about

### **Class of person/arrangement**

1. This Ruling explains the circumstances in which materials and spare parts held by persons carrying on a business providing services for reward (for example, a builder, tradesperson, repairer or other service provider) are 'trading stock' as defined in section 70-10 of the *Income Tax Assessment Act 1997* ('the 1997 Act').
2. The Ruling does not deal with the alternative methods of valuing materials and spare parts that are trading stock.
3. In this Ruling:
  - (a) the word 'materials' refers to articles of any kind required for making or doing something in the course of providing services but does not extend to consumable stores; and
  - (b) the expression 'spare parts' refers to parts for use in replacing, faulty, worn, broken or obsolete parts of something in the course of providing services.

### **Cross reference table of provisions**

4. In this Ruling, a reference to a provision in the 1997 Act should be read, where appropriate, as a reference to the equivalent provision in the *Income Tax Assessment Act 1936* ('the 1936 Act'). The following table provides cross references between the relevant

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provisions of the 1997 Act and the corresponding provisions in the 1936 Act:

| <b>1997 Act</b>              | <b>1936 Act</b>  |
|------------------------------|------------------|
| section 70-10                | subsection 6(1)  |
| section 70-35                | section 28       |
| subsections 70-40(1) and (2) | section 29       |
| subsection 70-45(1)          | subsection 31(1) |
| no equivalent provision yet  | section 170      |

**Ruling**

5. Materials and spare parts held by a taxpayer who produces, manufactures, or acquires (referred to in this Ruling for brevity as 'obtains') them for supply to customers are 'trading stock' within the ordinary meaning of the term if:

- (a) the taxpayer is, or will be, carrying on a business providing services to customers for reward; and
- (b) the materials or spare parts are supplied by the taxpayer to the customer in the course of, and as an essential part of, performing the services; and
- (c) the materials or spare parts are separately identifiable things before and after the services are provided which retain their individual character or nature, that is, they are not used up or significantly changed in performing the services; and
- (d) the materials or spare parts are to be disposed of, that is, property in them is to pass to the customer.

6. Materials and spare parts also fall within the extended statutory meaning of the term 'trading stock' in section 70-10 if they are either:

- (a) 'produced, manufactured, or acquired' ('obtained') and are held for purposes of sale in the ordinary course of a business providing services for reward. This is so if, for instance:
  - (i) the materials or spare parts are sold or disposed of under a contract in which a separate charge is made for the materials and spare parts supplied; and

- (ii) the materials or spare parts are separately identifiable things before and after the services are provided which retain their individual character or nature, that is, they are not used up or significantly changed in performing the services; or
  - (b) obtained and are held for purposes of exchange in the ordinary course of a business if, for instance, the spare parts are supplied in return for a customers' defective parts.
- 7. Materials or spare parts that are supplied by a taxpayer to customers, but only as a minor and incidental aspect of providing services to the customer, are not 'trading stock'.

## **Date of effect**

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- 8. This Ruling applies only from and including the 1997-98 year of income unless a taxpayer chooses to apply it to earlier income years. Assessments for income years earlier than 1997-98 may be amended if a taxpayer wishes, but only to the extent permitted by section 170 of the 1936 Act. Application of this Ruling to earlier income years is only available if the value of trading stock ascertained by the taxpayer is calculated on reasonably objective and supportable data.
- 9. The Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

## **Explanations**

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### **Scope of the term 'trading stock'**

#### ***Statutory definition of 'trading stock'***

10. Section 70-10 provides that, in the absence of a contrary intention:

' "Trading stock" includes:

- (a) anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of a business; and
- (b) live stock.'

11. The definition uses the word 'includes' and is therefore expansive. A thing is trading stock for income tax purposes if it is

within the statutory definition in section 70-10 or within the ordinary meaning of the term.

### *Ordinary meaning of 'trading stock'*

12. Materials and spare parts held by a taxpayer who obtains them for supply to customers are 'trading stock' within the ordinary meaning of the term if:

- (a) the taxpayer is, or will be, carrying on a business providing services to customers for reward, for example, as a builder, tradesperson, repairer or other service provider; and
- (b) the materials or spare parts are supplied by the taxpayer to the customer in the course, and as an essential part, of performing the services; and
- (c) the materials or spare parts are separately identifiable things before and after the services are provided which retain their individual character or nature, that is, they are not used up or significantly changed in performing the services; and
- (d) the materials or spare parts are to be disposed of; that is, property in them is to pass to the customer.

13. The expression 'retain their individual character or nature' in subparagraph 12(c) means that the form, state or condition of the materials or spare parts when disposed of to the customer is essentially the same as that when the materials or spare parts are held by the service provider.

14. For example, building materials supplied by a builder in the course of contracts for building, extending or renovating premises retain their character or nature as building materials and are an essential part of the services. So too, materials and spare parts supplied by an electrician or plumber in providing their services retain their character or nature as materials and spare parts and are an essential part of the services. These things are 'trading stock'.

15. Paint held by an artist or by a house painter is not 'trading stock'. On providing the service (that is, doing a painting or painting a house), the paint is no longer in the same essential form, state or condition that it was in when it was held by the artist or house painter. Similarly, solder used by an appliance repairer in repairing circuits or other parts in appliances, or amalgams supplied by a dentist in providing dental treatment is not 'trading stock' because the solder in the repaired appliance, or the amalgam in the dental treatment is no longer in the same essential form, state or condition that it was in when it was held by the repairer or the dentist.

16. Materials or spare parts that are supplied by a taxpayer to customers, but only as a minor aspect of providing services to the customer, are not 'trading stock'.

17. If materials or spare parts are within the ordinary meaning of 'trading stock', they are trading stock for the purposes of the Act: *FC of T v. Suttons Motors (Chullora) Wholesale Pty Ltd* (1985) 157 CLR 277; 85 ATC 4398; (1985) 16 ATR 567. In that case, the High Court of Australia said (CLR at 281-282; ATC at 4400; ATR at 570):

'The ordinary meaning of the term "trading stock" upon which sec. 6(1) [the equivalent of section 70-10 in the new Act] builds is that which is attributed to it by legal and commercial people for accounting and other purposes. That ordinary meaning has been held to include shares purchased and held for resale by a share trader (*Investment and Merchant Finance Corporation Ltd. v. Federal Commissioner of Taxation* (1971) 125 CLR 249) and land which a dealer in land holds as an object of his dealing: *St Hubert's Island Case* ((1978) 138 CLR at 225). It has been said to include the stock of raw materials which a manufacturer holds for use in manufacture: *St Hubert's Island Case* ((1978) 138 CLR at 226-227) and cf. Act, s. 6(1). It is not necessary for present purposes however to explore the outer limits of the area covered by that ordinary meaning of the term. Its traditional and narrower denotation still lies at the centre of that meaning and is adequate for present purposes. That denotation is of goods held by a trader in such goods for sale or exchange in the ordinary course of his trade.'

18. See also *John v. FC of T* (1989) 166 CLR 417 at 429; 89 ATC 4101 at 4107; (1989) 20 ATR 1 at 7.

19. It is clear from what the High Court said in the *Suttons Motors* case, however, that the ordinary meaning of that term extends beyond the traditional (and narrower) denotation referred to in that case.

20. Materials or spare parts are trading stock for income tax purposes if they are within the meaning of the term without the aid of the definition, that is, it is 'trading stock' in the ordinary sense of the term. The definition of 'trading stock' in section 70-10 does not restrict the ordinary meaning of the term 'trading stock'.

21. *The Macquarie Dictionary* defines 'trading stock' to mean 'stock not held for permanent investment'. The word 'stock' means the aggregate of goods which a trader has on hand as a provision for the possible future requirements of customers: see *The Shorter Oxford English Dictionary*, vol II, at 2133. The word 'trade' is commonly used 'to denote operations of a commercial character by which [a] trader provides to customers for reward some kind of goods or

services' (see *Ransom (Inspector of Taxes) v. Higgs* [1974] 3 All ER 949 per Lord Reid at 956 and *Kowloon Stock Exchange Ltd v. Inland Revenue Commissioner* [1985] 1 All ER 205 at 210).

22. In some respects we consider that the dictionary definitions of 'stock' are too broad to apply to the expression 'trading stock' in its context in section 70-10. We take the view that the ordinary meaning of 'trading stock' encompasses the aggregate of materials or spare parts which a taxpayer has on hand if:

- (a) the taxpayer is, or will be, carrying on a business providing services to customers for reward; and
- (b) the materials or spare parts are supplied by the taxpayer to the customer in the course, and as an essential part, of performing the services.

***Extended statutory meaning of 'trading stock'***

23. Materials and spare parts also fall within the extended statutory meaning of the term 'trading stock' in section 70-10 if they are either:

- (a) 'produced, manufactured or acquired' ('obtained') and are held for purposes of sale in the ordinary course of a business providing services for reward. This is so if, for instance;
  - (i) the materials or spare parts are sold or disposed of under a contract in which a separate charge is made for the materials and spare parts supplied; and
  - (ii) the materials or spare parts are separately identifiable things before and after the services are provided which retain their individual character or nature, that is, they are not used up or significantly changed in performing the services; or
- (b) obtained for purposes of exchange if, for instance, the spare parts are supplied in return for a customers' defective parts: compare Taxation Ruling TR 93/20, paragraph 59.

24. For example, if a dentist provides an account to a patient which itemises the cost of gold and other materials and also the cost of labour used in making an inlay, the gold and other materials is not trading stock, even though a separate charge is made for them, because they are used up or significantly changed in the process of making the inlay.

25. The definition of the term 'trading stock' in section 70-10 extends the scope of the term in its ordinary sense.

26. The definition operates 'cumulatively upon the ordinary meaning' of trading stock and confers 'added meaning for the purposes of the Act': *FC of T v. St Hubert's Island Pty Ltd* (1978) 138 CLR 210; 78 ATC 4104; (1978) 8 ATR 452 per Stephen J at CLR 216; ATC 4106-7; ATR 454-455 and see, to the same effect, Mason J at CLR 229; ATC 4113-4; ATR 463 and Jacobs J at CLR 235; ATC 4117; 8 ATR 467.

### **Contrast with consumable stores**

27. The treatment of materials and spare parts in this Ruling should be contrasted with the treatment of consumable stores in Taxation Rulings IT 333 and TR 93/20, paragraphs 26, 105 and 106. Consumable stores such as fuel, oil, lubricants, detergents and glue, by their very nature, are not 'trading stock'. They are destroyed, consumed or expended by use by the taxpayer in carrying on business and property in them does not pass (whether as goods or in some other form) to customers.

## **Examples**

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### **Example 1**

28. A1 Master Plumbing Services holds at all times a stock of PVC pipes, elbow joints, tap washers, glue, etc., to repair customers' burst water pipes, downpipes, drains, etc.

29. The PVC pipes, elbow joints and tap washers are trading stock. They are disposed of by A1 Master Plumbing Services to its customers in the course, and as an essential part, of performing its plumbing services and the pipes, elbow joints and tap washers retain their individual character or nature. The glue, on the other hand, is not trading stock. It is a consumable store because it is destroyed or expended by use by A1 Master Plumbing Services in carrying on its business and property in the glue does not pass, as glue, to customers.

### **Example 2**

30. U-Bent-It panelbeaters purchased replacement side panels, doors and paint on 29 June 1996 for repair of a motor vehicle. No repair work had commenced on the vehicle as at 30 June 1996.

31. The side panels and doors are trading stock because they will be disposed of by U-Bent-It to its customer in the course, and as an essential part, of performing its services. Also, the side panels and doors retain their individual character or nature. The paint is not

trading stock because, when it is used in undertaking the repair of the vehicle, the paint will no longer be in the same essential form, state or condition that it was in when it was held by U-Bent-It.

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### ATO references

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- Australasian Jam Co Pty Ltd v. FC of T (1953) 88 CLR 23; (1953) 10 ATD 217
- FC of T v. St. Hubert's Island Pty Ltd (1978) 138 CLR 210; 78 ATC 4104; (1978) 8 ATR 452
- FC of T v. Suttons Motors (Chullora) Wholesale Pty Ltd (1985) 157 CLR 277; 85 ATC 4398; (1985) 16 ATR 567
- Investment and Merchant Finance Corporation Ltd v. FC of T (1971) 125 CLR 249
- John v. FC of T (1989) 166 CLR 417; 89 ATC 4101; (1989) 20 ATR 1
- Kowloon Stock Exchange Ltd v. Inland Revenue Commissioner [1985] 1 All ER 205
- Ransom (Inspector of Taxes) v. Higgs [1974] 3 All ER 949

### *subject references*

- consumables
- containers and packing materials
- materials
- spare parts
- trading stock

### *legislative references*

- ITAA97 70-10
- ITAA97 70-35
- ITAA97 70-40(1)
- ITAA97 70-40(2)
- ITAA97 70-45(1)
- ITAA36 6(1)
- ITAA36 28
- ITAA36 29
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- ITAA36 170