

TR 2009/D2 - Income tax: trading stock - treatment of discounts, rebates and other trade incentives offered by sellers to buyers

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Draft Taxation Ruling

Income tax: trading stock – treatment of discounts, rebates and other trade incentives offered by sellers to buyers

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What this Ruling is about

1. This draft Ruling applies to a seller who sells trading stock to a buyer and to a buyer who purchases trading stock from a seller where:

- trade incentives in the form of discounts, rebates or other incentives are received by the buyer from the seller in connection with the buyer’s purchase of trading stock;
- trade incentives or other payments not directly connected with the buyer’s purchase of trading stock are received by the buyer from the seller:
 - in consideration for the buyer providing a service in relation to the trading stock; or
 - to secure a real commercial benefit for the seller in relation to its brand or the future sale of its goods.

2. The draft Ruling clarifies the taxation treatment of transactions associated with trading stock for both the seller and the buyer. It deals with:

- the application of Division 70 of the *Income Tax Assessment Act 1997* (ITAA 1997)¹ to trade incentives; and
- the extent to which, and the time at which:
 - income is derived for the purposes of section 6-5; and
 - deductible outgoings or losses are incurred for the purposes of section 8-1.

3. In this draft Ruling:

- 'buyer' means any entity that purchases trading stock from a seller for the purposes of resale. The buyer may receive from the seller:
 - a trade incentive in the form of a discount, rebate or other incentive in connection with the purchase of its trading stock;
 - a payment not directly connected to the purchase of trading stock such as a payment received to undertake promotional activities to bolster sales of the relevant trading stock; or
 - a payment which secures a real commercial benefit for the seller in relation to its brand or the future sale of its goods;
- 'payment' of a trade incentive includes a credit allowed by a seller against a current or future liability of the buyer, or any application of an incentive amount by the seller at the direction of or for the benefit of the buyer; and
- 'seller' means an entity that sells trading stock to a buyer and that:
 - provides trade incentives to the buyer in the form of discounts, rebates or other incentives in connection with the sale of trading stock; or
 - makes payments to the buyer in connection with doing business with the buyer which secure for the seller a real commercial benefit in relation to its brand or the future sale of its goods.

¹ All subsequent legislative references are to the ITAA 1997 unless otherwise stated.

Ruling

Taxation consequences for buyer

4. Trade incentives that relate directly to the purchase of trading stock, so as to reduce the purchase price, are treated as a reduction in the cost of acquiring the trading stock for the buyer for the purposes of section 8-1 and Division 70.

5. An incentive that is subject to a condition that has not been satisfied at the time of the purchase does not relate directly to the purchase of trading stock and does not reduce the cost of acquiring trading stock for a buyer.

6. Where a trade incentive does not reduce the buyer's cost of acquiring trading stock, the trade incentive is ordinary income of the buyer. On the assumption that the buyer returns income on an accruals basis, the income will be derived in the income year in which it is earned.

7. Where a trade incentive is provided in respect of future acts and/or services (such as promotional services) to be performed by a buyer, and where the buyer is required to repay or in practice repays any part of the trade incentive attributable to any acts and/or services not performed, the trade incentive will be derived by the buyer for the purposes of section 6-5 at the time that the relevant acts and/or services are performed.

Taxation consequences for seller

8. Trade incentives that relate directly to the sale of trading stock, so as to reduce the sale price, are treated as a reduction of the sale proceeds for the seller for the purposes of section 6-5 and Division 70.

9. With one exception, an incentive that is subject to a condition that has not been satisfied at the time of the sale does not relate directly to the sale of trading stock and does not reduce the proceeds of sale for the seller. The exception is where there is virtual certainty at the time of sale that the condition will be satisfied. For example, a settlement discount that is always taken by the buyer will reduce the sale price for the seller. Similarly a volume rebate subject to a rebate threshold that has not been met but is certain to be met will reduce the sale price for the seller. In both instances the seller's assessable income from the sale will be the reduced amount.

10. Where a trade incentive does not reduce the selling price of trading stock for the seller, the seller deducts the amount of the trade incentive as a business expense in the income year in which it is incurred.

11. A seller may provide a trade incentive that subsidises, compensates, reimburses or rewards a buyer for carrying out activities or performing services (such as promotional services) or, in the absence of such activities or services, secures a real commercial benefit for the seller in relation to its brand or future sales of its goods. Such a trade incentive does not relate directly to the sale of the trading stock and does not reduce the cost of acquiring trading stock for the buyer and the proceeds of disposal for the supplier.

Whether the trade incentive directly relates to trading stock

12. Factors relevant to whether a trade incentive reduces the cost of acquiring trading stock for a buyer and the proceeds of disposal for the seller include:

- the terms of trading between the parties and other sales and transaction documentation, such as invoices, incentive claim forms and credit notes;
- an objective assessment of the intention of the parties; and
- any other relevant circumstances surrounding the payment of the incentive.

13. Where in substance a trade incentive is paid for more than one purpose, each purpose is considered in determining the extent to which the payment reduces the cost of acquiring trading stock for the buyer and the proceeds on disposal of the trading stock for the seller. If apportionment between each purpose cannot be accurately measured, the buyer should return the full amount of the trade incentive as income and the seller should return the full amount of the trade incentive as a business expense.

Examples

Example 1 – upfront volume rebate not subject to aggregate volume threshold – buyer and seller

14. Under its terms of trade with a seller, a buyer is entitled to receive a volume rebate of 5 per cent for all purchases of 5,000 or more items of trading stock. The buyer purchases 10,000 items of trading stock with a cost price of \$20 per item subject to the 5 per cent rebate.

15. The volume rebate is intended to reduce the selling price of the goods under the terms of trade in accordance with ordinary business practice. It is treated as a reduction in the cost of the purchase of trading stock by the buyer.

16. The volume rebate reduces the buyer's acquisition cost of the trading stock. The buyer's acquisition cost of the trading stock for income tax purposes is \$190,000.

17. Similarly the volume rebate reduces the sale proceeds of the seller for income tax purposes to \$190,000.

18. Whether or not the volume rebate is included on the sales invoice or is separately invoiced would not affect the income tax consequences. In the circumstances the volume rebate is in substance simply a reduction in the purchase/sale price, and the manner in which it is invoiced would not alter its character.

Example 2 – volume rebate subject to aggregate volume threshold – buyer and seller

19. Under its terms of trade with a seller, a buyer is entitled to receive a volume rebate of 2 per cent on its purchases of a particular item of trading stock subject to the buyer purchasing 100,000 items of the trading stock in an income year.

20. The parties initially proceed on the basis that the rebate is uncertain and treat the purchases as undiscounted at the time of purchase. The undiscounted purchase price of \$20 per item is paid by the buyer.

21. After six months, during which the buyer purchases 80,000 items of the trading stock, the parties conclude that it is certain that the volume rebate level will be achieved. From the seventh month the buyer pays the discounted purchase price of \$19.60 per item.

22. The number of items purchased by the buyer reaches 100,000 during the eighth month. At that time the seller credits the volume rebate of \$32,000 attributable to the first 80,000 items purchased by the buyer. The rebate is shown as a credit due to the buyer on the seller's sales invoice for the eighth month.

23. Throughout the year, including after the volume rebate threshold is considered certain and after the volume rebate threshold is achieved, the undiscounted purchase/sale price is shown on invoices and other documentation as the trading stock price and the volume rebate is shown separately.

24. The rebates applicable to the first 80,000 items do not reduce the cost of acquiring trading stock for the buyer and the proceeds of sale for the seller. The rebates are subject to a condition that has not been satisfied at the time of the sale, and it is not certain at the time of sale that the condition will be satisfied. A later satisfaction of that condition does not retrospectively alter the purchase/sale price applicable to earlier transactions at the time the transactions were undertaken.

25. The rebates applicable to the next 20,000 items do not reduce the cost of acquiring trading stock for the buyer but reduce the proceeds of sale for the seller. Whilst the rebates are subject to a condition that has not been satisfied at the time of the sale, it is certain in a practical sense at the time of sale that the condition will be satisfied. The seller treats the volume rebates as a reduction in the sale price of the trading stock in accordance with the principles as set out in Taxation Ruling TR 96/20 for settlement discounts.

26. The rebates applicable to all subsequent items reduce the cost of acquiring trading stock for the buyer and the proceeds of sale for the seller as the rebates are not subject to a condition that has not been satisfied at the time of the sale.

27. The rebate of \$32,000 applicable to the first 80,000 items is derived as ordinary income of the buyer and incurred as an expense of the seller at the time when the seller credits the buyer's account with the \$32,000. In this example the crediting occurs when the number of items purchased by the buyer reaches 100,000. The rebate applicable to the next 20,000 items is ordinary income derived by the buyer when the number of items purchased by the buyer reaches 100,000 in accordance with the principles as set out in TR 96/20 for settlement discounts.

Example 3 – ullage allowance – buyer and seller

28. Under its terms of trade with a seller a buyer is entitled to an ullage allowance of 1.5 per cent on all delivered stock. The allowance is taken off the invoiced price of the goods. The buyer is entitled to return damaged stock for a refund, but the ullage allowance saves the buyer and the seller the cost of administering returns and refunds within the normal range of stock breakages.

29. The ullage allowance is paid in effect as consideration for short deliveries of marketable stock due to damage and is a reduction in the cost of stock. The buyer takes into account the reduction of 1.5 per cent in determining the deductible outgoing it incurs in acquiring stock from the seller.

30. The income of the seller is the list price less the 1.5 per cent ullage allowance.

Example 4 – characterisation of trade incentive – settlement discount – buyer and seller

31. Over a number of years a buyer's terms of trade with a seller have included an entitlement to a prompt payment discount where payment is made within 30 days. The buyer has always claimed the prompt payment discount whether or not it pays the invoice within 30 days, and the seller allows the discount without objection.

32. Despite what occurs in practice the prompt payment discount is an incentive subject to a condition that has not been satisfied at the time of purchase and will not reduce the cost of acquiring trading stock for the buyer. The amount incurred by the buyer for the purposes of section 8-1 is determined by the contractual terms of trade between the parties, and at the time the transaction is implemented the buyer has no right to the prompt payment discount. The fact that the seller always allows the prompt payment discount is something that occurs later and does not reduce the amount that the buyer has incurred under the contract.

33. The buyer will include the amount of the discount in its assessable income in the income year in which its entitlement to the discount arises.

34. As it is certain that the prompt payment discount will be taken by the buyer and allowed by the seller, the prompt payment discount will reduce the sale price for the seller. The seller's assessable income from the sale will be the reduced amount. To include the gross sale price in the assessable income of the seller would, as per *Ballarat Brewing Co v. FC of T (Ballarat Brewing)*,² produce a 'misleading' result.

Example 5 – characterisation of trade incentive – promotional rebate – buyer and seller

35. Under its terms of trade with a seller, a buyer is entitled to receive a promotional rebate for keeping a prominent display of the seller's range of products in its stores. The amount of the rebate is calculated as a percentage of the sale price of goods purchased.

36. Other promotional rebates paid by the seller include a payment for generic shelving, a payment for placing the goods in an advantageous position, for example on a gondola end, or a non-specific payment for promotion at the discretion of the buyer.

37. The promotional rebate is payment for services provided by the buyer to the seller. Even though the amount of the rebate is calculated by reference to the volume of stock purchased by the buyer, it is properly characterised as a payment for services. The rebate is ordinary income of the buyer and does not reduce the buyer's cost of acquisition of trading stock from the seller for the purposes of Division 70.

38. For the seller, the payment of the rebate is a deductible loss or outgoing. The payment does not reduce the proceeds from the sale of stock to the buyer or the income the seller derives from the sale transaction.

² (1951) 82 CLR 364 at 369; (1951) 9 ATD 254 at 258.

Example 6 – promotional rebate derived upfront – buyer

39. On 31 May a buyer purchases trading stock from a seller and receives from the seller a trade incentive in consideration for promotional services to be performed by the buyer over the following three months. The seller and the buyer have a long standing business relationship, the trade incentive payment is not linked to any specific services to be performed by the buyer, and nor is there any provision for any repayment of the trade incentive having regard to the level of services actually performed by the buyer.

40. The buyer performs the promotional services over the three months period in accordance with the agreement with the seller.

41. The incentive is derived by the buyer for the purposes of section 6-5 on 31 May. The monies received or receivable by the buyer as at 31 May are not subject to the discharge by the buyer of any future obligations.

Example 7 – promotional rebate derived when services performed – buyer

42. On 31 May a buyer purchases trading stock from a seller and receives from the seller a trade incentive in consideration for promotional services to be performed by the buyer over the following three months. To the extent that the services are not performed the buyer is required to make a pro rata repayment of the trade incentive to the seller.

43. The buyer performs the promotional services over the three months period in accordance with the agreement with the seller.

44. The incentive is derived by the buyer for the purposes of section 6-5 over the three months period. One third of the amount paid is derived as at 30 June with the remaining two thirds derived in the following income year. Any monies received or receivable by the buyer as at 31 May are subject to the discharge by the buyer of certain future obligations. The assessable income of the buyer as at 30 June will include that proportion of the trade incentive representing obligations discharged, and therefore income earned, as at 30 June.

Example 8 – apportioned bundled rebate – buyer and seller

45. Under its terms of trade with a seller, a buyer is entitled to a 5 per cent rebate on certain major brand goods in consideration for the volume of goods purchased and for the buyer's commitment to achieve an increased level of sales. While the buyer is under no obligation to undertake any specific promotion of the seller's goods, the parties understand that the buyer will promote the seller's goods throughout the year in order to achieve the increased sales. In its ordinary promotional activity the buyer conducts promotions of major brand goods, including the seller's products, more intensively than lesser brands.

46. The fact that the buyer conducts a higher level of promotional activity for the major brand goods of the seller and has committed to increase its sales of those goods indicates that the parties intend some part of the rebate to be paid as consideration for promotional activities, even though the greater part of the rebate may relate to the volume of stock purchased.

47. Having regard to all the relevant factors, such as the amount the buyer usually charges for undertaking specific promotions on behalf of a seller and the relative frequency of promotions of the seller's goods, the buyer determines that 40% of the rebate is paid as consideration for promotional activity. This part of the rebate does not reduce the cost of acquiring trading stock from the seller for the purposes of Division 70.

48. For an item of stock with a sale price of \$100 there will be a \$5 rebate. The 'promotional activity' component of the rebate will be \$2 and the 'volume' component of the rebate will be \$3. The volume rebate will reduce the buyer's cost of acquiring the item of trading stock to \$97.

49. On the assumption that the seller obtained information from the buyer on the proportion that relates to promotional activity, the proportions which apply to the buyer would apply to the seller. Accordingly the seller would show sale proceeds of \$97 and claim a deduction for \$2. If the seller cannot obtain information from the buyer on the proportion that relates to promotional activity, it must determine that proportion on all the relevant information available to it, including its cost of purchasing other promotional activities from the buyer.

Example 9 – unapportioned bundled rebate – buyer and seller

50. Under its terms of trade with a seller, a buyer is entitled to a 4 per cent rebate on certain major brand goods. The rebate is intended to cover a range of trade incentives and, in the interests of administrative efficiency and to minimise costs, the parties do not dissect the rebate into its component parts.

51. As neither the buyer nor the seller can make a bona fide estimate of the amount attributable to the promotional activity, the buyer's cost of an item of trading stock is the undiscounted amount and the seller treats the undiscounted amount as the sale proceeds. The buyer should return the 4 per cent rebate as income and the seller should claim the 4 per cent rebate as a business expense.

Example 10 – advertising allowance – buyer and seller

52. Under its terms of trade with a seller, a buyer is entitled to an advertising allowance for including the seller's products in its advertising material a minimum number of times a year. The allowance is expressed as a percentage reduction in the price of goods on all of the seller's invoices.

53. The advertising allowance is a payment for services which the buyer provides to the seller. For the buyer the allowance is ordinary income and is not a reduction in the cost of acquisition of trading stock for Division 70 purposes.

54. For the seller, the advertising allowance is a payment for services provided to it by the buyer. The allowance does not reduce the proceeds from the sale transaction and accordingly does not reduce the amount of income the seller derives on the disposal of trading stock to the company. It is a business expense.

Example 11 – transport rebate – buyer

55. A seller makes a contribution to the buyer's transport costs in recognition of the buyer's capacity to widely distribute the seller's goods and for the use of the buyer's distribution centre.

56. For the buyer, if the rebate is merely a contribution to the overall transport and distribution cost, the payment is either a reduction in that cost or ordinary income.

57. However, if the amount of the rebate can be directly linked to and is dependent on the number of units purchased, it would be treated as a reduction in the cost of acquisition of trading stock.

Date of effect

58. When the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will 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 75 to 77 of Taxation Ruling TR 2006/10).

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.*

Scheme of Division 70

59. The payment of trade incentives by sellers to buyers is a common feature of the business conducted between them.

60. Section 70-1 states that Division 70 deals with 'amounts you can deduct, and amounts included in your assessable income' where 'you acquire an item of trading stock'.

61. Section 70-5 states that the purpose of income tax accounting for trading stock is to produce an overall result that properly reflects 'your activities with your trading stock during the income year.' The three key features of this tax accounting regime are:

- gross outgoings and earnings, rather than net profits or losses on disposal, are brought to account;
- those gross outgoings and earnings are on revenue account, with gross outgoings being usually deductible as general deductions under section 8-1 and gross earnings usually assessable as ordinary income under section 6-5; and
- any difference between the value of trading stock on hand at the start and at the end of the income year is brought to account as assessable income (if the difference is positive) or as a deduction (if the difference is negative).

62. Section 70-15 provides a timing rule to ensure that deductions for an item of trading stock are available only in the income year in which the item is first on hand or in which it produces income on disposal.

63. Subsection 70-15(1) refers to 'an outgoing incurred in connection with acquiring an item of trading stock.' The deductible amount (the 'gross outgoing' referred to in section 70-5) is the actual cost to the trader of acquiring the item. All elements that contribute to the actual cost of the item of trading stock, such as trade incentives that in reality reduce the cost, are intended to be taken into account.

64. The expression 'incurred in connection with acquiring' means that amounts unconnected with the acquisition of the item, such as selling costs or amounts received in connection with providing services or maintaining a business relationship, are not included in the cost of the trading stock for the purposes of Division 70. These amounts are directed at an end other than the acquisition of the trading stock.

65. In summary, the scheme of Division 70 requires a trader to apply a tax accounting methodology to its trading stock that effectively defers a deduction on the acquisition of an item of trading stock to the income year in which income from that item is assessed. The scheme recognises the trader's profits and losses that inhere in its trading stock on hand.

66. Dealings with trading stock will ordinarily result in the derivation of ordinary income under section 6-5 and the deductibility of expenses under section 8-1. Nothing in Division 70 reveals an intention that the application of section 6-5 and section 8-1 is modified for trading stock.

Sections 6-5 and 8-1 apply generally to incentives in accordance with the principles set out in TR 96/20

Section 6-5

67. TR 96/20 addresses the income tax treatment of settlement discounts by analysing them in terms of the law applying to the derivation of income and the deductibility of outgoings. The Ruling requires certain other incentives to be treated in the same way as settlement discounts.

68. Under TR 96/20, when a seller sells trading stock to a buyer that is subject to trade incentives, the income that the seller derives from the transaction is the contract price, net of any incentives that reduce the contract price.

69. With one exception, a trade incentive that is subject to a condition that has not been satisfied at the time of the sale does not reduce the contract price of the trading stock. Accordingly, and subject to that exception, the seller has derived the full amount of the contract or sale price as assessable income.

70. The exception is where, even though the incentive may be subject to a condition satisfied at a later date, there is virtual certainty at the time of sale that the incentive will be paid. For example, the buyer may always take a settlement discount regardless of when the buyer pays for the trading stock. In this scenario the seller will have no expectation that anything other than the reduced price (contract price less settlement discount) will be paid. The income tax consequences for the seller are as set out in *Ballarat Brewing*³ where Fullager J considered whether the taxpayer should include the discounted price (the 'company's figure') or the undiscounted contract price (the 'commissioner's figure') in its assessable income:

³ (1951) 82 CLR 364; (1951) 9 ATD 254.

Which figure – the Commissioner's or the company's – represents, or more nearly represents, the truth and reality of the situation? The company's figure brings into account what the company will, in the light of all past experience and policy, almost certainly receive in respect of book debts - no more and no less. The commissioner's figure brings into account sums which the company will certainly, or almost certainly, not receive in respect of book debts. A trading account and profit and loss account based on the latter figure would be misleading, and there is nothing in the Act which requires the assessment of income on the basis of accounts which would be misleading in this respect.⁴

71. Section 6-5 applies to the seller in accordance with the decision in *Ballarat Brewing*. However, it does not follow that because income is assessed to the seller in a particular way for the purposes of section 6-5, the section 8-1 deductions allowable to the buyer will correspond in both quantum and timing to the income assessed to the seller. Notwithstanding the position of the seller, the position of the buyer remains as set out in paragraphs 11 and 57 of TR 96/20. Paragraph 57 states:

Although the opportunity for the customer to avail itself of the discount is provided in the contract of sale and, therefore, exists at the time of sale, the right to the discount itself does not. The right to the discount is only triggered by the payment of the discounted price within the discount period. At the time of sale, the right to a discount 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 a discount provides no more than an opportunity for the customer to acquire the goods at an actual cost less than their contracted price. In these circumstances, the incurrance of the liability under the contract of sale and the later satisfaction of that liability are two separate, albeit related events.

72. In relation to the buyer, TR 96/20 provides that the undiscounted contract price is the presently existing liability and the deductible outgoing from the purchase, as this amount is not uncertain or contingent. The settlement discount merely provides the buyer with an opportunity to vary the contract price of the goods and does not reduce the liability to which the buyer is definitively committed at the time of sale.

73. Should the buyer later become entitled to the settlement discount by satisfying its conditions, the discount is ordinary income assessable to the buyer under section 6-5.

74. TR 96/20 also addresses the treatment of cash discounts, trade discounts and quantity or bulk discounts, where the conditions for payment are satisfied at the time of the purchase/sale. These incentive payments reduce the contract price of the goods and, as a consequence, the loss or outgoing incurred by the buyer and the assessable income of the seller.

⁴ (1951) 82 CLR 364 at 369; (1951) 9 ATD 254 at 258.

75. At the time TR 96/20 was issued, settlement discounts did not reduce the cost of purchase under the accounting standards for inventories. Under the current Australian Accounting Standards, consistent with the International Financial Reporting Standards, that position has been reversed. However, while the accounting standard for inventories now states that ‘trade discounts, rebates and other similar items are deducted in determining the costs of purchase’,⁵ such a change does not of itself alter the interpretation and application of income tax law.

76. The principles under which ordinary income is derived under section 6-5 and outgoings or losses are incurred under section 8-1 are well established.

77. It is also well established that accounting standards and principles do not affect the taxation consequences where the taxation principles are clear.

78. In *Queensland Independent Wholesalers Limited v. FCT (Queensland Independent Wholesalers)*,⁶ Hill J (with whom Davies and Lee JJ agreed) considered the relevance of accounting standards to the sales tax treatment of certain trade incentives directed towards particular ends:

While in my view it is not necessary that the amount of a rebate be given contractually to reduce the amount at which the goods are sold, it is clear that the factual circumstances must be such that it is apparent that the rebate does effect a reduction in the sale price as a matter of commercial reality and that it is not directed at some other end. The cash component of the 1985 rebate clearly enough satisfies such a test. However, I think that other considerations arise when one considers that part of the rebate, which was credited and provided a mechanism for ensuring an additional capital injection for RSDF, should it be needed. The rebate, while it could be said in one sense to reduce the sale price of the goods, went far beyond that. It was not a mere rebate against the price of the goods, but rather was directed at another end. In those circumstances the non-cash component did not operate to reduce the amount for which the goods were sold to customers.⁷

79. Similarly in *Colgate-Palmolive Pty Ltd v. FCT (Colgate-Palmolive)*⁸ the Full Federal Court stated that:

A characterisation of the co-operative allowance as a payment directed towards providing a discount to Woolworths does not give adequate expression to the factual context in which the allowance was paid. As the trial judge correctly recognised (at p 4762), Woolworths was able to derive revenue from making available to its sellers marketing opportunities with little or no marginal cost to it. Viewed in that light, the co-operative allowance was not in the nature of a rebate off the price of goods for some matter incidental to the sale transaction. Rather it was a sum paid to secure a benefit to Colgate in relation to its brand, or in relation to the sale of goods in the future.

⁵ AASB 102.11 (operative 1 July 2007).

⁶ 91 ATC 4492; (1991) 22 ATR 45.

⁷ 91 ATC 4492 at 4500; (1991) 22 ATR 45 at 54.

⁸ 99 ATC 4289; (1999) 41 ATR 357.

Whilst the manner in which Colgate and Woolworths accounted for the co-operative allowance is a relevant factor in assessing the price at which Colgate's products were sold to Woolworths, it cannot be determinative of that question. When regard is had to the substance of the relationship between the parties, the accounting treatment cannot alter the fact that the co-operative allowance was directed at another end than the payment of a discount to Woolworths, namely the securing of a real independent commercial benefit to Colgate.⁹

80. The Commissioner's view is that the principles as stated in *Queensland Independent Wholesalers* and *Colgate-Palmolive*, whilst expressed in a sales tax context, also apply in an income tax context. It can be accepted that accounting standards will be of assistance in considering when income is derived by a business for the purposes of section 6-5 in circumstances where neither the legislation nor judicial authority provides any assistance. However where, on the particular facts, trade incentives are directed towards particular ends, those ends will ordinarily determine the income tax outcomes. For example, where an entity makes a payment in consideration for obtaining a service, that payment cannot be characterised as a reduction in the sale proceeds of trading stock and/or as a reduction in the cost of acquiring trading stock for income tax purposes merely because the applicable accounting standards permit or require such a characterisation in the entity's statutory accounts.

81. Therefore, where the trade incentive does not relate directly to its sale of trading stock, the seller includes the contract price for the trading stock in its assessable income and claims a deduction for each incentive paid in the income year in which the expense is incurred.

82. If an incentive which is ordinarily paid as a matter of course (*Ballarat Brewing* scenario) and reduces the sale proceeds is subsequently not paid, the seller derives the amount of the incentive as income when it becomes certain that the amount will not be paid.

83. A buyer includes any trade incentive that does not relate directly to its purchase of trading stock as assessable income in the income year in which it is derived.

When does a buyer derive a trade incentive as income?

84. Paragraph 8 of Taxation Ruling TR 93/11 states that:

A professional person will sometimes receive fee income in advance of the work to which it relates. If the contract or arrangement requires that the fee be paid in advance, the fee income is derived in the income year in which the professional person completes the work (or the part of the work) to which the fee relates. On the other hand, if the client simply pays early, the fee income is derived when a recoverable debt arises or would have arisen if the client had not paid early

⁹ 99 ATC 4289 at 4293-4294; (1999) 41 ATR 357 at 362.

This statement relies on the decision in *Arthur Murray (NSW) Pty Ltd v. FC of T*¹⁰ where it was held that income received in advance for the provision of services to be rendered in future income years and 'subject to the contingency that the whole or some part of it may have in effect to be paid back, even if only as damages, should the agreed *quid pro quo* not be rendered in due course'¹¹ is not derived until the services are rendered.

85. The principles applicable to a 'professional person' in relation to prepaid and unearned fee income would also apply to an unearned trade incentive that is ordinary income of a buyer. To the extent that a trade incentive received by or owing to a buyer is a fee for future services and will be repaid to the seller should the relevant services not be performed, the trade incentive would be unearned income of the buyer to be derived for the purposes of section 6-5 at the time the services are performed.

Section 8-1

86. The Commissioner's view is that accounting standards and principles are not relevant to the characterisation of trade incentives for the purposes of section 8-1. The decisions in *Queensland Independent Wholesalers* and *Colgate-Palmolive* as discussed in paragraphs 78 to 80 of this Ruling in an income derivation context are equally applicable in a section 8-1 'incurred' context.

87. Moreover, court decisions suggest that accounting standards and principles will be of less relevance in determining when a 'loss or outgoing ... is incurred' than when income is derived. For example, in *FC of T v. Citylink Melbourne Ltd*,¹² Crennan J stated that 'accruals based tax accounting and the jurisprudence in respect of the test for deductibility could not always be reconciled with a commercial or accounting approach'.¹³ Crennan J referred to a number of cases which demonstrate that 'incurred' has a precise legal meaning. There are no suggestions in any of the cases that the meaning of 'incurred' would change in parallel with changes in relevant accounting standards.

88. Therefore, where the trade incentive does not relate directly to its sale of trading stock or where the seller has not reduced its sale proceeds in accordance with the *Ballarat Brewing* decision, the seller claims a deduction for each incentive paid in the income year in which the expense is incurred.

¹⁰ (1965) 114 CLR 314; (1965) 14 ATD 98.

¹¹ (1965) 114 CLR 314 at CLR 319; (1965) 14 ATD 98 at 100.

¹² 2006 ATC 4404; (2006) 62 ATR 648.

¹³ 2006 ATC 4404 at 4424-4425; (2006) 62 ATR 648 at 675.

89. A buyer disregards a trade incentive that does not relate directly to its purchase of trading stock and claims the contract price as the deduction. Where a trade incentive relates directly to its purchase of trading stock the buyer deducts the trade incentive from the contract price and claims the net (discounted) amount as the deduction.

Standard trade incentives

Upfront volume rebates not subject to aggregate volume threshold

90. Where a buyer purchases trading stock that is subject to a volume rebate at the time of purchase based on the quantity purchased, the purchase/sale price of the trading stock is the net amount.

91. The volume rebate is not a condition that has not been satisfied at the time of the purchase/sale. The volume rebate relates directly to the purchase/sale and the price of the trading stock, is a benefit provided to the buyer at the time of purchase for entering into a contract to purchase a particular quantity, and is essentially a reduction in the contract price. Accordingly it reduces the purchase price of the buyer and the sale price of the seller.

Promotional incentives

92. A promotional incentive is an example of a trade incentive paid as consideration for, or in recognition of, things that a buyer does for the benefit of a seller.

93. Product promotion is an important factor in commerce and can be linked directly to the volume of sales. Promotions therefore benefit the seller as well as the buyer. It is common for buyers to seek financial contributions from sellers for promoting the seller's products.

94. Promotional incentives can take different forms. A buyer may charge a specific amount for a specific product promotion. A buyer may claim a percentage rebate on its purchase of the seller's goods for undertaking general promotions of the seller's goods over a particular period in order to increase the buyer's sales of the seller's goods. Whilst the buyer may retain complete discretion as to the timing and nature of these promotions, it is understood that a certain level of promotion will be necessary to achieve the increased sales.

95. The fact that the buyer must undertake promotions as part of its ordinary retail operations in order to remain competitive does not affect the nature of the incentive payments. They are amounts paid by the seller on the understanding that the buyer carries out promotional activity from which the seller expects to benefit. Promotions are necessarily preferential, and the seller pays the incentive in recognition that its products will enjoy preferential promotional treatment in accordance with the incentive to the extent necessary to achieve increased sales.

96. Although in the course of its normal retail activities a buyer may be expected to promote certain popular brands of goods more intensively than other brands, if the buyer claims an incentive payment from a seller in association with the buyer's promotional activities, it is reasonable to conclude that the buyer is being rewarded by the seller for services performed in relation to the seller's goods from which the seller is benefiting.

97. A seller's purpose in paying a promotional incentive is to increase its sales and sales revenue. This purpose is directed to things that occur after the seller sells the trading stock to the buyer. For this reason a promotional rebate lacks the necessary connection to the sale to be categorised as an adjustment to the sale price. The promotional rebate does not reduce the sales proceeds for the seller or the outgoing incurred by the buyer in acquiring the trading stock.

98. The fact that a trade incentive may be calculated as a percentage of the selling price of goods may indicate that more careful consideration of its real purpose is required, but it does not prevent its characterisation as a promotional payment, that is, as a payment for services that does not reduce the purchase/sale price of the goods.

99. In summary, where:

- an incentive is paid to promote sales of the seller's products;
- the parties have a mutual understanding that increased sales will not occur unless the buyer carries out a certain level of promotional activity or a certain promotional program; and
- the buyer carries out that level of promotional activity or that promotional program;

it is reasonable to conclude that the seller pays the incentive as consideration for the buyer promoting the seller's products with a view to increasing sales.

Bundled incentives

100. A bundled incentive may be described as a consolidated or combined incentive that relates to a number of types of incentive.

101. Where the component parts of a bundled incentive are not valued, the parties must determine on an objective basis what proportion of the bundled incentive relates to each type of incentive. In determining these proportions, the parties need to have regard to the reasons for the payment of the bundled incentive including any services performed by the buyer for the seller and the benefits obtained by the seller in consideration for the making of the payment.

102. If the component parts of a bundled incentive cannot be accurately measured, the buyer should return the full amount of the bundled incentive as income and the seller should return the full amount of the bundled incentive as a business expense. Division 70 deals with 'an outgoing incurred in connection with acquiring an item of trading stock' (refer subsection 70-15(1)). Where no component of a bundled trade incentive can be quantified and attributed to 'acquiring an item of trading stock', the bundled incentive will be income of the buyer and a business expense of the seller.

Appendix 2 – Alternative views

❶ *This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.*

Alternative view: settlement discounts and volume rebates which are certain and which reduce the sale proceeds of the seller also reduce the buyer's cost of trading stock

103. Where the sales income of the seller is reduced under the *Ballarat Brewing* principle it should follow that the deduction allowable to the buyer under section 8-1 in respect of its purchase of trading stock is correspondingly reduced.

104. In characterising a trade incentive for the purposes of Division 70, it is important to identify the real character of the payment and whether the payment is integral to the sale transaction or is a separate transaction in its own right.

105. For example, where in a practical sense it is certain that a volume rebate level will be achieved at the time of the purchase/sale, the parties would deduct the amount of the rebate from the gross purchase/sale price in determining the purchase price of the buyer and the sale price of the seller for the purposes of Division 70.

106. Where achievement of the volume rebate level is uncertain, it would be expected that the parties would treat the gross purchase/sale price as the purchase/sale price of the trading stock and treat the volume rebate, should it arise, as a separate transaction.

107. Where a volume rebate level previously considered uncertain is achieved or is considered certain to be achieved, amounts paid by the seller to the buyer representing rebates attributable to the period during which the volume rebate level was uncertain would be ordinary income of the buyer which would not reduce the buyer's cost of the trading stock, and would be a revenue expense of the seller which would not reduce the seller's disposal proceeds. A later legal obligation to make payment of a volume rebate applicable to an earlier purchase/sale transaction would not retrospectively reduce the purchase/sale price applicable to the earlier transaction.

108. From the time commencing when the volume rebate level is achieved, or when it is certain that it will be achieved, it would be expected that the parties would deduct the amount of the rebate from the gross purchase/sale price and treat the net amount as the actual purchase/sale price of the trading stock.

109. The Commissioner does not accept this view. The position of the buyer is set out in TR 96/20. The then applicable accounting standards were not considered relevant to the amount of the deduction allowable to the buyer in respect of its purchase of trading stock, and any changes to the accounting standards made since TR 96/20 was issued are similarly not relevant to the amount of the deduction now allowable to the buyer in respect of its purchase of trading stock consistent with the discussion of *Queensland Independent Wholesalers* and *Colgate-Palmolive* in paragraphs 78 to 80 of this Ruling.

110. The Commissioner does not accept that trade incentives that apply to all transactions under the terms of trade reduce the purchase/sale price of the trading stock. The Commissioner's view is that where the buyer's entitlement to a trade incentive is dependent on the buyer fulfilling one or more conditions, the incentive payment is earned and is income of the buyer and, similarly, is a loss or outgoing and a deductible expense of the seller. *BHP Billiton Petroleum (Bass Strait) Pty Ltd & Anor v. FC of T (BHP Billiton Petroleum (Bass Strait))*¹⁴ involved a question of when income was derived for the purposes of section 6-5 where, having regard to the terms of the contracts between the relevant parties, there was neither judicial precedent nor any specific legislative provision.

111. The Commissioner recognises the importance of commercial and accounting principles in certain contexts including the *BHP Billiton Petroleum (Bass Strait)* context. For example, Taxation Ruling TR 2006/8 deals with the valuation of cost of trading stock on hand at cost and refers to judicial authority to support the view that cost is determined having regard to accounting standards and principles. The Ruling quotes Mason J's view (*FC of T v. St Hubert's Island Pty Ltd (in liq)*) (*St Hubert's Island Pty Ltd*)¹⁵ that:

as the definition of 'trading stock' contained in sec. 6(1) is not an exclusive definition, it requires us to give effect to the ordinary, and in this case that happens to be the commercial, meaning of the expression

and Jenkinson J's assumption (*Philip Morris Ltd v. FC of T (Phillip Morris Ltd)*):¹⁶

that the legal conception of what is required, or permitted, by subsection 31(1) when a manufacturer exercises his option to value an article of trading stock at cost may be enlarged or varied by proof of relevant changes in accounting principle or practice

¹⁴ 2002 ATC 5169; (2002) 51 ATR 520.

¹⁵ 78 ATC 4104 at 4113; (1978) 8 ATR 452 at 462).

¹⁶ 79 ATC 4352 at 4357; (1979) 10 ATR 44 at 48.

112. *BHP Billiton Petroleum (Bass Strait), St Hubert's Island and Philip Morris* confirm the relevance of commercial and accounting principles in resolving taxation questions in certain contexts. However, in the Commissioner's view, commercial and accounting principles are necessarily subordinate to taxation principles where they differ and where the taxation principles are clear. Where as a matter of fact a particular trade incentive is paid for a particular purpose, that purpose will determine the taxation consequences. Treating certain trade incentives as income of the buyer and business expenses of the seller does not, in the words of Hill and Heerey JJ, 'produce a misleading result'.

113. The Commissioner's view is that there is no basis for preferring a taxation outcome based on an accounting treatment in accordance with current accounting standards over a taxation outcome based on the application of well established legal principles to a particular set of facts.

Appendix 3 – Your comments

114. You are invited to comment on this draft Ruling. Please forward your comments to the contact officer by the due date.

115. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the Tax Office website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: 12 June 2009
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Appendix 4 – Detailed contents list

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 93/11; TR 96/20; TR 2006/8;
TR 2006/10

Subject references:

- acquisition of trading stock
- discounts
- promotional rebates
- trading stock
- volume rebates, deferred credits, trade incentives

Legislative references:

- ITAA 1936 6(1)
- ITAA 1936 31(1)
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 Div 70
- ITAA 1997 70-1
- ITAA 1997 70-5
- ITAA 1997 70-15
- ITAA 1997 70-15(1)

Case references:

- Arthur Murray (NSW) Pty Ltd v. FC of T (1965) 114 CLR 314; (1965) 14 ATD 98
- Ballarat Brewing Co v. FC of T (1951) 82 CLR 364; (1951) 9 ATD 254
- BHP Billiton Petroleum (Bass Strait) Pty Ltd & Anor v. FC of T 2002 ATC 5169; (2002) 51 ATR 520
- Colgate-Palmolive Pty Ltd v. FCT 99 ATC 4289; (1999) 41 ATR 357
- FC of T v. Citylink Melbourne Ltd 2006 ATC 4404; (2006) 62 ATR 648
- FC of T v. St Hubert's Island Pty Ltd (in liq) 78 ATC 4104; (1978) 8 ATR 452
- Philip Morris Ltd v. FC of T 79 ATC 4352; (1979) 10 ATR 44
- Queensland Independent Wholesalers Limited v. FCT 91 ATC 4492; (1991) 22 ATR 45

Other references:

- Australian Accounting Standard AASB 102

ATO references

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