TR 92/D37 - Income tax: assessability of incentives (manufacturers' credits) arising from the purchase or order of new aircraft

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Australian Taxation Office

Draft Taxation Ruling
Income tax: assessability of incentives (manufacturers' credits) arising from the purchase or order of new aircraft

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What this Ruling is about

1. Aircraft manufacturers often provide incentives to purchasers in consideration for their entering into agreements to purchase or order new aircraft. Within the aircraft industry, these incentives are commonly known as *manufacturers' credits*.

2. This Ruling considers:

(a) whether a manufacturer's credit in the aircraft industry gives rise to assessable income according to ordinary concepts under subsection 25(1) of the *Income Tax Assessment Act 1936;* or

(b) whether a manufacturer's credit in the aircraft industry reduces the purchase or order price of the aircraft in respect of which it issues.

3. Some of the key terms used in this Ruling are defined in paragraph 11.

Ruling

(a) Assessable income

4. A manufacturer's credit in the aircraft industry gives rise to assessable income under subsection 25(1) in the hands of the purchaser unless it can properly be characterised as a discount on the purchase or order price of the aircraft in respect of which it issues (see

paragraphs 7 to 9 of this Ruling). A manufacturer's credit gives rise to assessable income irrespective of whether it is:

(a) a cash incentive; or

(b) a non-cash incentive that is convertible to cash; or

(c) a non-cash incentive that is not convertible to cash.

(In relation to (c), section 21A treats non-convertible property or services provided after 31 August 1988 in the context of a business relationship as if they were convertible to cash in determining the income derived by a taxpayer.)

5. The purchaser derives the income when the right to receive a manufacturer's credit becomes unconditional. This is so even if the purchaser has a further choice about how it uses the benefit. If a manufacturer's credit is transferred to (or applied for the benefit of) an associated entity or another person, carried to any reserve, or otherwise dealt with on the purchaser's behalf or as the purchaser directs, section 19 deems the purchaser to have derived the income arising from the manufacturer's credit.

6. In our view, manufacturers' credits typically provided in the aircraft industry give rise to assessable income under subsection 25(1).

(b) Reduction in purchase price

7. A manufacturer's credit in the aircraft industry reduces the purchase or order price (rather than giving rise to assessable income under subsection 25(1)) if it can properly be characterised as a discount on the price of the aircraft in respect of which it issues. Whether a manufacturer's credit can properly be characterised as a discount needs to be determined by reference to the facts of each case, and especially by reference to the terms of the agreement and any associated arrangements entered into between the manufacturer and the purchaser. One must have regard to both the intention and the conduct of the parties.

8. We consider that there can be a discount only if there is a **direct** reduction in the amount payable on the invoice for the aircraft in respect of which a manufacturer's credit issues. The manufacturer's credit is not a discount if it is applied to some other liability of the purchaser to the manufacturer or some other party. It is rare for a manufacturer's credit taken in cash to be a discount.

9. In our view, manufacturers' credits typically provided in the aircraft industry are not discounts. Rather, they give rise to assessable income under subsection 25(1) (see paragraphs 4 to 6 of this Ruling).

Date of effect

10. This Ruling (that is, the final Taxation Ruling based on this Draft Taxation Ruling) sets out the current practice of the Australian Taxation Office. It applies (subject to any limitations imposed by statute) for years of income commencing both before and after the date on which it is issued.

Definitions

11. The following definitions of key terms apply for this Ruling:

'aircraft'

- includes airframes or engines (or both).

'manufacturer's credit'

- means the incentive (cash and or non-cash) made available to the purchaser of the aircraft by the manufacturer. The non-cash incentive consists of
    (i) the credit that can be applied towards the cost of goods and services; or
    (ii) the provision of goods or services.

'credit memorandum'

- means a credit voucher issued by the aircraft manufacturer evidencing a manufacturer's credit made available other than as cash or goods and services provided directly.

Explanations

Typical manufacturer's credit arrangements in the aircraft industry

12. There are certain characteristics common to most manufacturer's credit arrangements in the aircraft industry.

13. The terms of sale of the aircraft are specified in the purchase agreement. However a manufacturer's credit is negotiated by way of letters and supplementary agreements. The letters and supplementary agreements are separate from the purchase agreement.

14. Under the letters and supplementary agreements a manufacturer's credit comes into existence as a consequence of entering into an agreement to purchase or as a result of the later confirmation of specific orders for purchase.

15. A manufacturer's credit can give rise to a credit memorandum. Normally a credit memorandum is expressed as having a dollar value and can be converted to cash or applied against any existing or later debt owing to the aircraft manufacturer. In some instances, a credit memorandum may be applied against a debt owing to a supplier other than the manufacturer which issued it.

16. A manufacturer's credit normally relates to a specific order for goods or services and generally become available on delivery of those goods or services. However, in some instances, it may be made available when the purchaser places or confirms the order.

17. Examples of those goods and services are:

(a) airframes;

(b) engines;

(c) simulators;

(d) special features (aircraft specifications);

(e) spare parts;

(f) maintenance support;

(g) service and repairs; and

(h) computer support.

18. A manufacturer's credit can also arise in other circumstances. For example, in consideration of a purchaser entering into agreements to purchase new aircraft to update its fleet, an aircraft manufacturer may agree to act as a selling agent for the used aircraft being replaced. An additional incentive in the form of a manufacturer's credit may be provided by the aircraft manufacturer to the purchaser in respect of any aircraft the purchaser sells independently. The value of the manufacturer's credit receivable in respect of each aircraft sold independently is reflected in letters and supplementary agreements.

19. Non-cash incentives made available other than by the issue of credit memorandums include goods and services provided to the purchaser for no cost or a reduced cost. Goods and services in this category commonly include:

(a) computer software/hardware;

(b)pilot training;

(c) spare parts/equipment; and

(d)engines.

(a) Assessable income

20. Whether or not a particular receipt is income depends on its quality or character in the hands of the recipient (*Scott v. FC of T* (1966) 117 CLR 514 at 526; (1966) 14 ATD 286 at 293).

21. We consider that the following factors support our view that manufacturers' credits typically provided in the aircraft industry give rise to assessable income under subsection 25(1):

(a) the benefit conferred on the purchaser is provided under an agreement separate from the purchase agreement;

(b) a manufacturer's credit is made available in consideration of entering into further purchase agreements or confirming existing orders; and

(c) although a manufacturer's credit can be traced to a specific aircraft acquisition, there is no requirement for the credit to be applied against the purchase of that aircraft.

22. In our view, manufacturers' credits are incentives made available as an inducement for:

(a) entering into an agreement to purchase aircraft; or

(b) exercising a separate contractual right to confirm an existing order.

23. We consider that a manufacturer's credit gives rise to assessable income under subsection 25(1) because it arises in the ordinary course of carrying on the purchaser's business. It is received as an ordinary incident of carrying on that business.

24. Even if - contrary to our view - a manufacturer's credit did not arise in the **ordinary** course of the purchaser's business, we would still consider that it gave rise to assessable income under subsection 25(1). This is because, in our view, the transaction giving rise to the manufacturer's credit is a commercial transaction. It forms part of the purchaser's business activity and a significant purpose of it is the obtaining of a commercial profit by way of the manufacturer's credit.

25. We consider that the views expressed in paragraphs 23 and 24 are supported by the reasoning of the High Court of Australia in *FC of T v. The Myer Emporium Ltd* (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693 and that of the Full Federal Court of Australia in *FC of T v. Cooling* 90 ATC 4472; (1990) 21 ATR 13 (especially at ATC 4484; ATR 26-27 per Hill J). In *Cooling's case*, the Federal Court held that a cash lease incentive paid to induce a taxpayer to enter into a lease of business premises was assessable income of the taxpayer.

(b) Reduction in purchase price

26. Our view is that a manufacturer's credit reduces the purchase or order price (rather than giving rise to assessable income under subsection 25(1)) only if it can be properly characterised as a discount. The term 'discount' has no technical or universal meaning (*Buchanan v. MacDonald* (1895) 33 Scottish Law Reporter 200 at 201 per Lord M'Laren).

27. The *Macquarie Dictionary* defines the verb 'discount' as 'to deduct, as a certain amount in settling a bill; make a reduction of'. In our view, this definition implies a notion of directness in determining what is a discount. If it did not, the words 'in settling a bill' would be superfluous. Accordingly, we consider that there can be a discount only if there is a direct reduction in the amount payable on the invoice for the account in respect of which the manufacturer's credit issues.

28. We consider that manufacturers' credits typically provided to purchasers in the aircraft industry differ both in form and substance from discounts. The typical manufacturer's credit arrangement is not directed to the purchaser's legal or practical obligation in respect of the particular aircraft in respect of which it issues. Rather, it confers positive benefits on the purchaser

Examples

29. The following are examples that demonstrate how cash and non-cash incentives (including those convertible/non-convertible to cash) should be treated for income tax purposes:

Example 1

30. *A manufacturer's credit which is taken in cash or applied against the cost of other goods and services.*

A manufacturer provides the following incentives to a purchaser via a letter agreement in consideration for entering into a purchase agreement for 5 aircraft at a cost price of USD 35m. per aircraft:

(i) airframe credits: USD 5m. per aircraft; and

(ii) engine credits: USD 500,000 per aircraft.

The credits become available on delivery of the aircraft. The credits can be utilised in various ways and are utilised as follows:

(i) USD 10m. airframe credits and USD 2.5m engine credits taken in cash;

(ii) USD 5m. airframe credits applied towards the purchase of spare parts; and

(iii) USD 10m. airframe credits taken as reimbursement for costs associated with the purchase of other goods and services provided by an unrelated manufacturer.

The USD 25m. airframe credits and the USD 2.5m. engine credits would be assessable income under subsection 25(1).

Example 2

31. *A manufacturer's credit which is applied against the cost of goods and services which give rise to that credit.*

A purchaser agrees to buy 10 new aircraft (designated as aircraft A to J) at a cost of USD 35m. per aircraft. In consideration for entering into the purchase agreement, the purchaser receives the following incentives:

(i) airframe credits	USD 5m. per aircraft; and
(ii) engine credits	USD 500,000 per aircraft.

The credits become available when the order is confirmed. The letter agreement(s) provide that the credits can be taken in cash, applied against spare parts or applied against the cost of the aircraft acquired.

The airframe credits are utilised as follows:

(i) USD 25m. against the cost of aircraft A;

(ii) USD 25m. against the cost of aircraft B; and

(iii) the engine credits of USD 5m. are taken in cash.

The only amount(s) that would be recognised as a "discount" in the cost price would be the USD 5m. credit applicable to aircraft A and the USD 5m. applicable to aircraft B. The balance of the airframe credits and engine credits would be assessable pursuant to subsection 25(1).

Example 3

32. *Non-cash incentives (convertible to cash)*

An airline enters into a purchase agreement to acquire 10 aircraft. The letter agreements provide for the following benefits:

(i) 2 engines at no cost (list price of USD 6m. each) and

(ii) spare parts and associated equipment (list price of USD 10m.).

Such benefits will be considered to be readily convertible to cash and considered as income according to ordinary concepts. Accordingly USD 22m. is income by virtue of subsection 25(1). Subsection 21(1) will deem the amounts to be paid or given.

Example 4

33. *An airline purchases some aircraft,and as an inducement to enter into the purchase agreement, the manufacturer provides computer software specific to the airline's needs for pilot training.*

These incentives are not convertible to cash, however, they are assessable as incentives under subsection 25(1) and will be treated as convertible to cash under subsection 21A(1). The value of the benefit will be its arms length value. This applies to non-cash business benefits provided on or after 31 August 1988. The assessable value may be reduced under subsection 21A(3) under the otherwise deductible rule.

Commissioner of Taxation

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- FC of T v. Myer Emporium Ltd. (1987) 163 CLR 199, 87 ATC 4363, (1987) 18 ATR 693
- FC of T v. Cooling 90 ATC 4472, (1990) 21 ATR 13
- Buchanan v. MacDonald (1895) 33 Scottish Law Reporter 200