TR 94/D4 - Income tax: assessability and deductibility of discounts offered by traders to their customers for prompt settlement of accounts

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Draft Taxation Ruling

Income tax: assessability and deductibility of discounts offered by traders to their customers for prompt settlement of accounts

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What this Ruling is about

1. A taxpayer engaged in a business of selling goods (a 'trader') may offer to its customers a discount for settling accounts promptly. The current practice in the trader's industry may be to offer to customers a discount for prompt payment, commonly called a 'settlement discount' or a 'cash settlement discount'. A customer might, for example, be offered a 5% settlement discount from the invoiced full cost of the goods if the customer settles his or her account within 30 days of the sale.

2. This Ruling deals with:

(a) The assessability under subsection 25(1) of the *Income Tax Assessment Act 1936* of the sale proceeds in the hands of the trader. Under this heading, the Ruling considers:

(i) whether the amount to be included in the trader's assessable income is the gross sale price or the discounted price of the goods;

(ii) when the sale proceeds are derived by the trader; and

(iii) whether the amount of the discount is derived by the trader , and if so when.

(b) The deductibility under subsection 51(1) of the purchase price of goods acquired by a customer as trading stock of

the customer's business. Under this heading, the Ruling considers:

(i) whether the amount to be allowed to the customer as an income tax deduction is the gross purchase price or the discounted price of the goods; and

(ii) when a loss or outgoing for purchase price and the amount of the discount is incurred by the customer.

3. This Ruling does not deal with trade discounts, volume discounts or deferred rebates offered by traders where the amount of the discount or rebate is determined by the number or value of purchases made by a customer over a period of time.

Ruling

Part A: assessability of sale proceeds

Amount to be included in assessable income

4. The amount to be included in the trader's assessable income when it derives the sale proceeds is the discounted or reduced price of the goods. This conclusion does not depend on the trader having habitually allowed discounts either generally or to the particular customer.

5. Whether the amount of the discount is later to be included in the trader's assessable income depends on whether the customer settles the account within the 30 days allowed for settlement. If the account is settled within 30 days, the discount is not included. If it is not settled within 30 days, the amount of the discount must then be included in the trader's assessable income.

When the sale proceeds and the amount of the discount are derived

- *derivation of sale proceeds*

6. The sale proceeds are derived when, under the contract of sale, the goods are sold and a debt is created. The debt is ordinarily created when the sale proceeds are due (in the sense of owing), even though they may only become payable at some future time. Sale proceeds are therefore derived when the price is due according to the terms of the particular contract of sale. If no time is specified in the contract, when payment is to be made may be established in appropriate cases by the previous course of dealing between the parties. Where no time of

payment can be so implied, payment would appear prima facie to be due when the seller informs the buyer that the seller is ready and willing to deliver possession of the goods since, by virtue of the Sale of Goods legislation, delivery of the goods and payment of the price are, unless otherwise agreed, concurrent conditions.

- *derivation of amount of discount*

7. The amount of the discount is not derived by the trader as income until the settlement period, i.e. 30 days, within which the discount is available to the customer, has expired and the customer has not paid the reduced price for the goods. If the customer does not settle the account within 30 days, the amount of the discount is then derived by the trader as income.

8. If goods are sold in one year of income and the 30 day settlement period does not expire until the following income year, the trader does not derive the amount of the discount (if the customer does not pay the reduced price for the goods within the 30 day period) until the latter year.

Part B: Deductibility of purchase price

Amount to be allowed as a deduction

9. A customer who:

- purchases goods from a trader as trading stock of the customer's business; and
- receives an account which provides for a discount for prompt payment e.g. 5% discount if payment is made within 30 days;

is entitled to an allowable deduction under subsection 51(1) only for the net amount i.e. the discounted purchase price of the goods.

10. Whether the customer is entitled to an allowable deduction for the amount of the discount depends on whether the customer settles the account within the 30 days allowed for settlement. If the account is settled within 30 days, the customer is not entitled to a deduction for the amount of the discount. If it is not settled within 30 days, the customer is then entitled to a deduction for the amount of the discount.

When the loss or outgoing is incurred

- *incurring the purchase price*

11. A loss or outgoing is incurred for the purchase price of the goods when, under the contract of sale, the customer is definitively committed to paying for the goods or completely subjects himself or herself to the payment. This ordinarily occurs when the customer is

under a presently existing liability to pay the purchase price of the goods. The question when a customer is under a presently existing liability to pay the purchase price of goods can only be conclusively determined by considering the particular facts of each case, especially the terms of the contract entered into for the purchase of the goods.

- *incurring the amount of the discount*

12. A loss or outgoing for the amount of the discount is not incurred by a customer until the settlement period, i.e. 30 days, the discount is available to the customer has expired and the customer has not paid the reduced price for the goods. If the customer does not settle the account within 30 days, a loss or outgoing for the amount of the discount is then incurred by the customer. It is only then that the customer is definitively committed to paying the amount of the discount to the trader in the sense that the customer is under a presently existing liability to pay that amount.

13. If goods are sold in one year of income and the 30 day settlement period does not expire until the following income year, a customer does not incur a loss or outgoing for the amount of the discount (if the customer does not pay the reduced price for the goods within the 30 day period) until the latter year.

Date of effect

14. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Part A: assessability of sale proceeds

15. Where a trader offers to customers a settlement discount from the price of goods sold on credit, an issue arises as to the appropriate taxation treatment to be adopted by the trader in relation to the amount of the discount.

16. Does the amount of discount need to be included in the trader's assessable income? If so, is it only included if the goods are not paid for by the customer before the period the discount is available to the customer has expired? Alternatively, does the full amount of the sale proceeds need to be included in the trader's assessable income and is a

deduction allowed for the amount of the discount if the customer avails of it?

17. In *Ballarat Brewing Co v. FC of T* (1951) 82 CLR 364; 9 ATD 254, where a brewing company sold its products with a discount for prompt payment and the discount was almost never refused or withdrawn, the company disclosed as income only the expected net price on each invoice. The High Court of Australia (Fullagar J) rejected argument for the Commissioner that the company should disclose the gross price and later claim a deduction for any discount allowed. His Honour agreed with the company's method of tax accounting (see 82 CLR at 368; 9 ATD at 257):

> 'I am of opinion that the contention of the company is correct. That contention was, as I have said, put in two ways, the question being treated in the alternative as being (1) a question of the ascertainment of assessable income, (2) a question of allowable deductions from assessable income. It does not appear to me that any question of allowable deductions really arises, or that section 51 of the Act has any bearing on this case. The matter seems to me to be a matter of arriving at the correct figure for a primary item in the relevant calculation, the correct figure to ascribe to 'sales' for the relevant accounting period.'

18. Fullagar J based his conclusion in the *Ballarat Brewing case* on the truth and reality of the situation being that it was the net prices only which would certainly, or almost certainly, be realised. The case may also be explained on the basis that the amount of the discount was not derived as income until the time expired within which the discount was available to the customer. This explanation accords with the notion of earning in the more recent decision of the High Court of Australia in *Arthur Murray (NSW) Pty Ltd v. FC of T* (1965) 114 CLR 314; 14 ATD 98. On this basis, we consider it irrelevant:

- whether the trader has habitually allowed discounts either generally or to the particular customer; or
- whether any discount offered has almost never been refused.

Amount to be included in assessable income

19. We take the view that the proper taxation treatment is for the trader to include the net proceeds of the sale in assessable income and to regard the trader's right to receive the amount of the discount as being a contingent right to receive income. The amount of the discount is only included in assessable income if the contingency occurs.

When the sale proceeds and the amount of the discount are derived

- *derivation of sale proceeds*

20. Where a taxpayer carries on a business of selling goods:

(a) the accruals (or earnings) basis is the appropriate method of determining the amount of income derived (*J Rowe & Son Pty Ltd v. FC of T* (1971) 124 CLR 421; 71 ATC 4157; 2 ATR 497; *Whitworth Park Coal Co Ltd (In Liq) v. IR Commissioners* [1961] AC 31 per Viscount Simonds at 62); and

(b) the income of the trading business is derived when its stock is sold and a debt is created - the debt need not be payable in the year of income (*J Rowe & Son Pty Ltd v. FC of T).*

21. If the trader does not offer its customers a settlement discount, the whole of the sale proceeds are derived by the trader when, according to the terms of the contract of sale, the sale proceeds mature into a recoverable debt i.e. a debt is created. A debt is created on the sale of the goods when the sale proceeds are due (in the sense of owing), even though they may only become payable at some future date: see, for example, *Ladenburg & Co v. Goodwin Ferreira & Co Ltd (in liq) and Garnett* [1912] 3 KB 275. Sale proceeds are therefore derived when the price is due according to the terms of the particular contract of sale. When the price is so due may occur before the seller is entitled to sue for the price. When the price is so due need not necessarily bear any relationship to the time property in the goods is transferred to the buyer or to the time the goods are delivered to the buyer. If no time is specified in the contract, when payment is to be made may be established in appropriate cases by the previous course of dealing between the parties. Where no time of payment can be so implied, payment would appear prima facie to be due when the seller informs the buyer that the seller is ready and willing to deliver possession of the goods since, by virtue of the Sale of Goods legislation (section 31 of the *Sale of Goods Act 1923* (NSW), section 35 of the *Goods Act 1958* (Vic), section 30 of the *Sale of Goods Act 1896* (Qld), section 28 of the *Sale of Goods Act 1895* (SA), section 28 of the *Sale of Goods Act 1895* (WA), section 33 of the *Sale of Goods Act 1896* (Tas), section 32 of the *Sale of Goods Act 1954* (ACT) and section 31 of the *Sale of Goods Act* (NT)), delivery of the goods and payment of the price are, unless otherwise agreed, concurrent conditions: *Benjamin's Sale of Goods* 4th ed Sweet & Maxwell London 1992 at paragraphs 8-004, 9-020 and 9-050.

22. If the trader offers its customers a settlement discount (e.g. a 5% discount for payment within 30 days) it is only the net amount of the

sale proceeds, i.e. the full sale price less the discount, that is derived by the trader when the sale proceeds are due.

- *derivation of amount of discount*

23. As the Full Federal Court of Australia said in *Barratt & Ors v. FC of T* (Gummow J, with whose reasons Northrop and Drummond JJ agreed) 92 ATC 4275 at 4281-2; (1992) 23 ATR 339 at 346:

> '....a debt that is presently recoverable by action generally will be an amount "derived" in the relevant sense by the creditor. The creditor will have a present right to receive the amount in question, something both earned and quantified, without the presence of any element of contingency or defeasibility. At the other end of the scale, where the right of the taxpayer is contingent, there will be no derivation before the contingency is satisfied: see Parsons, '*Income Taxation in Australia*', para. 11.49.'

24. If a trader offers its customers a settlement discount, the trader only has a contingent right to receive the amount of the discount. The trader's right to receive payment of the amount of the discount is contingent on the 30 day settlement period expiring without the customer paying the reduced price for the goods. There is no derivation of income until the contingency occurs. In other words, the trader does not derive the amount of the discount as income until:

(a) the 30 days have expired; and

(b) the customer has not paid the reduced price for the goods.

25. The amount of the settlement discount matures into a recoverable debt only after the 30 day settlement period has expired. Before then, the trader has no right to demand payment of the amount of the discount because the trader is only entitled to claim and receive the net sale proceeds i.e. the full sale price less the settlement discount. The full purchase price becomes payable at the end of the settlement period; the customer is not allowed a reasonable time, after delivery, in which to pay: see *Amos and Wood Limited v. Kaprow* (1948) WN 71; 64 TLR 110.

Part B: Deductibility of purchase price

Amount to be allowed as a deduction

26. As stated above, a customer who:

- purchases goods from a trader as trading stock of the customer's business; and

- receives an account which provides for a discount for prompt payment;

is only entitled to an allowable deduction under subsection 51(1) for the discounted purchase price of the goods.

27. The customer also has a contingent liability to pay the amount of the discount to the trader. The amount of the discount is only an allowable deduction if the contingency occurs.

28. Whether the customer is entitled to an allowable deduction for the amount of the discount depends on whether the customer settles the account within the 30 days allowed for settlement. If the account is settled within 30 days, the customer is not entitled to a deduction for the amount of the discount. If it is not settled within 30 days, the customer is then entitled to a deduction for the amount of the discount.

When the loss or outgoing is incurred

- *incurring the purchase price*

29. A customer who purchases goods from a trader as trading stock of the customer's business is entitled to allowable deductions under subsection 51(1) for the purchase price of the goods.

30. Expenditure on the purchase of trading stock, broadly speaking, qualifies as an allowable deduction in the year of income in which it is 'incurred' for the purpose of subsection 51(1).

31. A liability will be loss or outgoing 'incurred' for the purposes of subsection 51(1), even though it remains unpaid, if the taxpayer is definitively committed or has completely subjected himself or herself to the liability (see *FC of T v. James Flood Pty Ltd* (1953) 88 CLR 492 at 506). As Gibbs J said in *Nilsen Development Laboratories Pty Ltd & Ors v. FC of T* (1981) 144 CLR 616 at :

> '.....what is clearly necessary is that there should be a presently existing liability.'

32. A loss or outgoing is therefore incurred for the purchase of goods when, under a contract of sale, the customer is under a presently existing liability to pay the purchase price. In *FC of T v. Raymor (NSW) Pty Ltd* 90 ATC 4467; (1990) 21 ATR 458 the Full Court of the Federal Court of Australia held there that the purchaser of copper tubing for resale incurred the discounted purchase price when it bound itself as a party to the relevant contracts, and so, became committed to pay that amount. When a loss or outgoing for the purchase of goods is 'incurred' can only be conclusively determined by considering the particular facts of each case, especially the terms of the contract entered into for the purchase of the goods. The following contracts of

sale are indicative of the types of contracts that are entered into but are not intended to be an exhaustive list of such contracts:

- If the contract provides that the purchase price is due and payable on the delivery of the goods, we consider that the liability for the purchase price is incurred when the goods are delivered.
- If the contract provides that the purchase price is due on the delivery of the goods but may be paid by way of instalments, we consider that the liability for the purchase price is incurred when the goods are delivered.
- If the contract provides that the purchase price is due and payable on the receipt of an invoice, we consider that the liability for the purchase price is incurred when the invoice is received.

- *incurring the amount of the discount*

33. If a liability will arise only on the happening of a contingent event, an outgoing is not 'incurred' for the purposes of subsection 51(1) before that event: see *FC of T v. James Flood Pty Ltd* (1953) 88 CLR 492. In *Hooker Rex Pty Ltd v. FC of T* 88 ATC 4392; (1988) 19 ATR 1241 a majority of the Full Court of the Federal Court of Australia (Sweeney and Gummow JJ) said (88 ATC at 4400; 19 ATR at 1249-1250):

> '.... a loss or expenditure is not "incurred" in the necessary sense if it is no more than contingent, pending, threatened or expected, no matter how certain it is in the year of income that the loss or expenditure will occur in the future: *FC of T v. James Flood Pty Ltd* (1953) 88 CLR 492 at 507-508; *Nilsen Development Laboratories Pty Ltd & Ors v. FC of T* (1981) 144 CLR 616 at 623-624 (per Barwick CJ) and CLR at 632 (per Mason J).'

34. If a trader offers its customers a settlement discount, the customer only has a contingent obligation to pay the amount of the discount. The customer's obligation to pay the amount of the discount is contingent on the 30 day settlement period expiring without the customer paying for the goods. In these circumstances, the contingency precludes the liability to pay the amount of the discount from constituting an outgoing 'incurred' in the sense of being 'encountered, run into or fallen upon' as distinct from being 'no more than impending, threatened, or expected': see *New Zealand Flax Investments Ltd v. FC of T* (1938) 61 CLR 179 per Dixon J at 207-8; 5 ATD 36 at 49-50; *Coles Myer Finance Ltd v. FC of T* 93 ATC 4214 per Deane J at 4225; (1993) 25 ATR 95 at 109. In other words, the customer does not incur a loss or outgoing for the amount of the discount until:

(a) the 30 days have expired; and

(b) the customer has not paid the reduced price for the goods.

Examples

Example 1

35. A wholesaler of widgets sells $1000 worth of them on 15 June 1993, offering a retailer 5% discount if the widgets are paid for within 30 days of the sale. Whether the account is paid before 30 June 1993 or not, the wholesaler derives $950 as income by way of sale proceeds at the time of the sale in the 1993-94 income year. If the discount offered is not taken up by the retailer, the wholesaler derives the remaining amount of $50 in the income year 1994-95 and is required to include that amount in its assessable income in that year.

Example 2

36. On the same facts, the retailer would be entitled to an allowable deduction in the 1993-94 income year for the amount of $950 whether or not the retailer pays that amount before 30 June 1993. If the retailer does not take up the discount offer, he or she would be entitled to an allowable deduction for the remaining amount of $50 in the 1994-95 income year, i.e. after the settlement period has expired.

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