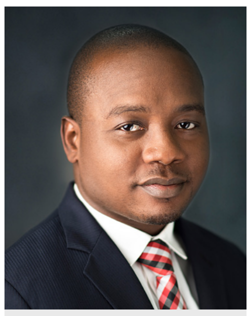
Andersen Tax Digest

Should trade discounts and rebates attract tax consequences?



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In today's competitive and challenging business environment, discounts and rebates are important promotional tools employed by manufacturing companies to promote the sale of products and stay ahead of competition. Amongst other strategies adopted by companies in expanding their market share, discounts and rebates have proven to be effective in ensuring companies increase their profitability, which also means more tax revenue for the government.

The above notwithstanding, tax authorities in Nigeria usually view discounts and rebates with skepticism. Sometimes, they seek to adjust the income tax computations of companies with the aim of de-recognizing the discounts and rebates and treating them as taxable items. This position can be quite punitive as it penalizes companies for offering discounts and rebates to grow their business notwithstanding that the Government might have enjoyed additional tax revenue from the increased profit.

In this article, we have highlighted the tax implications of discounts and rebates, the controversies surrounding their adoption and practical challenges for taxpayers.

Types of Discounts and Rebates

The Black's law dictionary defines discount as a reduction from the full amount or value of something especially, price while rebate is defined as a return of part of a payment, serving as a discount or reduction. In practice, both words are used inter-changeably to mean a reduction in the sales price of a product. In the event that other factors such as quality and packaging, are the same between two competing products, available discounts might be the only consideration in making a choice between the two products. Companies adopt different types of discounts to promote their products. These can be classified into two broad categories; volume and cash discounts.

Volume discounts are granted to customers to encourage large purchase of goods. It is widely used to reward customers who meet certain sales target within a specified time. For example, a company may give a certain percentage discount to customers who purchase five thousand cartons of products within the first quarter of the year. Where a customer meets this target, the company will credit the customer's ledger account with the discount amount, which can be used to purchase more products in the future.

On the other hand, cash discounts are granted to motivate customers to pay for purchased goods within a specified time or period, which is usually earlier than the time, or period the customer would have ordinarily paid for the goods. Cash discount can also be used as a tool to recover overdue debts from customers by offering incentives to customers whose debts will otherwise have gone bad. The purpose of cash discount is typically to improve the working capital conditions of the company. The underlying motive is not necessarily to improve sales but to encourage early payment for goods and services.

Controversies and practical experiences

Most manufacturing companies rely on the recommendations of the International Financial Reporting Standards (IFRS) 15, which specifies that revenue should be recognized, net of all discounts. Hence, the treatment of discount for tax purposes is usually one of the most disputed areas during routine audits and investigations of most manufacturing companies by the tax authorities.

Based on the provisions of the Value Added Tax (VAT) Act, VAT is applicable on the supply of goods and service of companies, except those specifically exempted. Further, the VAT Act provides that the value of taxable goods and services will be deemed as the monetary consideration received for the supply of such goods and services. In other instances, the market value of the goods and services supplied will be the consideration received where the supply is not for money consideration. Given that VAT is applicable only on the money consideration received for the supply of goods and services, where discount is granted to customers, the amount chargeable to VAT should be the net sales amount, which is the consideration received for the supply.

Notwithstanding the above, in most instances, the tax authority take a position to adjust the revenue reported in the financial statements upwards by not recognizing the discounts allowed reported in the books. This position is usually taken if the discount given is not reflected on the face of the invoices issued by the taxpayer to its customers. The non-recognition of the discounts often leads to additional companies' income tax (CIT) and VAT payable by the company. This risk is often prevalent since discounts are not often determined at the point of sale but when a target volume purchase is made by a customer (volume discounts), or when payment is made earlier than due date (cash discounts). To convince the tax authorities on the appropriate tax treatment of discounts, relevant supporting documents such as the company's discount policy, sample invoices, customer ledger account would be required to demonstrate how the company accounts for discounts granted to customers. The tax authorities may also request for a walk-through test.

With respect to cash discount, the consideration for the goods remains the sales price in the invoice and the reduction thereon is only based on early payment of the goods purchased. The tax authorities often argue that the drive to manage the working capital requirement of the company should not adversely affect the tax due to the government. To this end, the tax authorities usually take the position to disallow the cash discount granted to customers and subject same to VAT.

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Without prejudice to the above, there are instances where taxpayers have adopted other promotional schemes that are classified as discounts but do not essentially qualify as discounts under scrutiny. It is important to examine these schemes and evaluate the tax implications. There may be unintended tax consequences that may crystalize in the event of a tax audit. This may be substantial as such liabilities may attract penalty and interest.

Tax Treatment in other Jurisdictions

While Section 9(c) of the CIT Act provides a basis for subjecting discount received to CIT, there are no clear provisions in the tax laws on the CIT and VAT treatment of discounts granted and rebates. This is not the same in other jurisdictions where there are specific guidelines on the taxation of discounts granted and rebates.

For example, in Singapore, VAT is generally referred to as Goods and Service Tax (GST) and there are specific guidelines on the tax implication of trade discounts. GST is chargeable on the net discounted price of goods and services for both volume and cash discounts.

The practice in Canada is somewhat different as the treatment for cash and volume discounts differs. For cash discount, GST is applicable on the total invoice amount, even if the customer takes advantage of the discount offered. On the other hand, the applicability of GST on volume discounts depends on whether the discount was offered during or after the time of sale. Where volume discount is offered at the time of sale, GST will be applicable on the net invoice amount. However, where it is offered after the time of sale, certain rules have to be applied to ascertain the tax treatment.

In Kenya, VAT is chargeable on the discounted price of goods and services irrespective of whether it is cash or volume discount, provided that the discount is accounted for at the time of the supply and the taxpayer issues a tax invoice.

Conclusion

In the light of the controversies associated with the lack of uncertainties on the tax treatment of the various types of discounts, it is important to review the tax laws along these lines so taxpayers can conduct related transactions with certainty. A cue can be taken from other jurisdictions that have updated their tax laws to address the challenges associated with the ever-changing business climate. Taxpayers are advised to take proactive steps in reviewing their discount promotion policies to avoid possible adverse tax impact.

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