



QUESTION WE'VE BEEN ASKED

This item should be read in conjunction with the item - *Aircraft Overhaul Provisions – Transitional Issues* which deals with the operational transitional issues arising from the application of QB0057.

AIRCRAFT OVERHAUL PROVISIONS—DEDUCTIBILITY

Income Tax Act 2007, section DA 1(1)

All references are to the Income Tax Act 2007.

Question

We have been asked whether a provision for future expenditure for aircraft engine and airframe maintenance is deductible in the year the provision is made.

Answer

The provision for future expenditure, for which an amount is set aside in aircraft overhaul provisions, is not “incurred” in the year the provision is made, so cannot be deducted under section DA 1(1) in that year (or any other year).

Expenditure is incurred, and therefore deductible, in the year in which an operator pays or becomes obliged to pay for specific maintenance work.

Analysis

Background

Under civil aviation law, in order for an airworthiness certificate to remain in force, aircraft engines and frames must be overhauled after a specified number of hours of use. Given that the requirements for overhauls are known, the “flying hour cost” can be accurately estimated. Accordingly, many operators make provision for anticipated future expenditure, based on the flying hour cost (or on engine hours) in any given year, to cover the cost of future overhauls.

In the Inland Revenue Department Technical Ruling *Provisions for Overhaul of Aircraft Engines* at paragraph 20.50.5), the Commissioner stated that a deduction would be allowed for future aircraft overhaul expenditure in a year that a provision was made for this expenditure. The correctness of this statement has been questioned.

Deductibility—Meaning of “incurred”

Section DA 1(1) provides:

Nexus with income

- (1) A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) to the extent to which the expenditure or loss is—
 - (a) incurred by them in deriving—
 - (i) their assessable income; or
 - (ii) their excluded income; or
 - (iii) a combination of their assessable income and excluded income; or
 - (b) incurred by them in the course of carrying on a business for the purpose of deriving—
 - (i) their assessable income; or
 - (ii) their excluded income; or
 - (iii) a combination of their assessable income and excluded income.

Section DA 2(1) further provides that a person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature.

In terms of the relevant case law, for expenditure to be “incurred”, the taxpayer must have paid, agreed to pay, or become definitively committed to that expenditure (see, for example *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351, *AM Bisley & Co Ltd v Commissioner of Inland Revenue* (1985) 7 NZTC 5,096, *HW Coyle Limited v Commissioner of Inland Revenue* (1980) 4 NZTC 61,558, *Case M123* (1990) 12 NZTC 2,788).

In determining whether someone is definitively committed to expenditure, the test is whether, in light of all of the surrounding circumstances and disregarding theoretical contingencies, any legal obligation to make a payment in the future has accrued. A contingency that would not make any material difference to the accuracy of the estimated expenditure may be considered a merely theoretical contingency. In addition, a contingency that is sufficiently remote to be viewed as not being a “realistic contingency” may be disregarded.

Where there is no existing obligation for the future expenditure, at the time an operator makes a provision to meet the expenses for the overhaul to be undertaken in the future, the expenditure is not incurred. This analysis is consistent with the Commissioner’s view stated in the Interpretation Statement, “Meaning of ‘incurred’ - the Privy Council decision in the Mitsubishi case” in *Tax Information Bulletin* Vol Ten, No 6 (June 1998).

Obligations relating to aircraft maintenance are set out in rules made under Part 3 of the Civil Aviation Act 1990. The Civil Aviation rules provide that a person must not operate an aircraft unless it has a current airworthiness certificate. Further, an airworthiness certificate remains in force only if the maintenance of the aircraft is performed in accordance with the applicable requirements of Parts 43 (General Maintenance Rules) and 91 (General Operating and Flight Rules) of the rules. Relevantly, an aircraft operator must ensure compliance with the manufacturer’s recommended overhaul intervals.

Aircraft manufacturers specify that various parts of an aircraft must be replaced after a certain number of flying hours or after a certain period. An aircraft operator, therefore, has a statutory obligation to replace those parts at the expiration of the relevant number of flying hours or time (if they wish to keep flying in compliance with civil aviation legislation). Consequently, when parts are purchased or a service provider is instructed to undertake the maintenance work, a legal obligation to make a payment exists and the relevant expenditure will be incurred (and thus be deductible). However, until that time there is no legal obligation to undertake any overhaul or make any payment.

This can be distinguished from cases like *Mitsubishi* where the event giving rise to the legal liability (ie the sale of a defective vehicle) had already occurred but not been communicated to the taxpayer. In the case of aircraft overhauls, the event giving rise to the liability is the flying of a certain number of hours or the passage of a certain amount of time combined with the commercial imperative to keep the plane compliant and to continue to fly. Notwithstanding that it may be almost certain in some cases that this will occur in a future period, there is no legal obligation until the event has occurred.

In addition, in terms of the legal test (as established by case law) as to what is required for expenditure to be incurred, it is also considered that in relation to aircraft overhauls, it is possible that one or more contingencies exist that are more than theoretical and that, if they arose, they would result in the expenditure not being paid in the future. These include the sale, loss, or grounding of an aircraft. These contingencies may be more than merely theoretical in terms of the legal test because:

- some of the contingencies may be a real possibility (ie not sufficiently remote); and
- if any of the contingencies did occur, they would have a material effect on the accuracy of the estimated expenditure.

However, even if in a particular case the only contingencies were merely theoretical ones, the incurred test (provided from case law) would still not be satisfied because a legal obligation to make a payment does not exist at the time a provision is made.

Consequently, operators incur the expenditure for aircraft and airframe overhauls in the period in which the operator pays or becomes obliged to pay for the specific maintenance work.

Overhaul Services Contracts

If an operator has entered into a contract with a supplier to provide overhaul services (or goods) for the aircraft, expenditure is generally incurred when the operator is definitively committed under the terms of the contract to make a payment. In these circumstances, the expenditure, prima facie, may be deductible under section DA 1. However, when expenditure is incurred before services are performed (or before goods are used), section EA 3 (Prepayments) may also apply. When section EA 3 applies, the effect is that the “unexpired portion” of the expenditure at the end of an income year is treated as income (sections EA 3(3)(a) and CH 2) and a deduction is

allowed for the same amount in the following income year (sections EA 3(3)(b) and DB 41). Section EA 3 may continue to apply until the unexpired portion is used up.

Leased Aircraft

If an operator leases an aircraft pursuant to a lease contract that provides for periodic maintenance based on flying hours or elapsed time, the deductibility requirements will generally be the same as for owned aircraft (ie the expenditure is not incurred until there is a definitive commitment to make a payment). In the case of leased aircraft, the obligation to undertake an overhaul may arise by virtue of statute (civil aviation regulations) or contract (the terms of the lease). However, until an aircraft operator has a legal obligation to make a payment, no deduction is allowed. When a lease contract provides that maintenance must be undertaken at the end of the lease regardless of the number of flying hours or elapsed time that has passed, an operator may be definitively committed under the terms of the contract to make a payment. This depends on the terms of the contract. In these circumstances the expenditure, prima facie, may be deductible under section DA 1. However, section EA 3 may also apply. This would depend on the exact terms of the contract.

Submissions Received

The Inland Revenue Department received submissions on the exposure draft for this item. In particular, submissions asked why the exposure draft stated that no legal obligation existed if civil aviation regulations mandated that aircraft be overhauled after a specified number of flying hours. In this regard it is accepted that civil aviation regulations impose a legal obligation on aircraft operators to overhaul their aircrafts if they wish to maintain a valid airworthiness certificate. At issue is the timing of that legal obligation in relation to deductions claimed.

For example, suppose a provision is made in Year 1, for an overhaul that will be required in Year 3. No legal obligation exists in Year 1 for the overhaul to be undertaken. At that time the operator is free to fly the aircraft without breaching any civil aviation regulations and the Civil Aviation Authority cannot prosecute the aircraft operator for not undertaking the overhaul (because it is not required until Year 3). While it may be certain in a practical sense that the overhaul will be required in Year 3, this is not sufficient to constitute a legal obligation in Year 1.

At any time until the time the overhaul is required in Year 3, the operator could stop flying the aircraft and, therefore, never be required to undertake the overhaul. This is inconsistent with the view that a legal obligation to overhaul exists in Year 1.

An overhaul is undertaken to ensure that the aircraft is airworthy for the period following the overhaul and before the next overhaul. The expenditure therefore relates to the period after the overhaul, not the period just completed. This is consistent with the fact that income earned after the overhaul will generally be derived for tax purposes as the operations take place. Allowing a deduction in a prior overhaul period would lead to a mismatch of income and expenditure.



Several submissions also referred to the hardship that would be caused to aircraft operators having to transition from their current tax treatment to the treatment set out in this statement. The item - *Aircraft Overhaul Provisions - Transitional Issues* considering the transitional issues has been published in response to these concerns.

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