by KEITH HARVEY & GEORGE KOLLIOU
Ambry Legal, Melbourne & McGrath Kolliou & Associates

GST treatment of lease, hire purchase and chattel mortgage facilities

GST trap for SME's

CASE STUDY

Colin is registered for GST on a cash basis. When he traded in a business motor vehicle the car salesman explained that he would be entitled to claim back the input tax credit on the new vehicle. Never one to miss a tax rort, Colin decided to spend more than he had originally contemplated and financed the vehicle by way of hire purchase.

Colin was shocked to later learn from his accountant that he would have to pay GST on the value of the trade-in vehicle and that he was not entitled to claim the input tax credit up front on the new vehicle. Why is this so, and how should the salesman have advised Colin to finance the vehicle?

INTRODUCTION

One of the most common transactions entered into by a business is the purchase of vehicles, plant and other equipment. It is also common to finance the acquisition by way of a lease, hire purchase, or chattel mortgage facility. What is the difference between these products, and what GST consequences flow from the choice made by a SME client?

The tax law gives us a clear definition of the term hire purchase however there is no definition of the term lease or chattel mortgage. While most tax practitioners understand the difference between these products the Commissioner has had occasion to warn tax agents that his audit investigations have found that tax payers are sometimes confused, for example, hire purchase rentals are often claimed as a tax deduction in the mistaken belief that the contract was in fact a lease.[1]

The term "hire purchase agreement" is defined in s 995-1 of the *Income Tax Assessment Act 1997* ("ITAA 97") as:

> (a) a contract for the hire of goods where:
>
> (i) the hirer has the right or obligation to buy the goods; and
>
> (ii) the charge that is or may be made for the hire, together with any other amount payable under the contract (including an amount to buy the goods or to exercise an option to do so), exceeds the price of the goods; and
>
> (iii) title in the goods does not pass to the hirer until the option to purchase is exercised; or
>
> (b) an agreement for the purchase of goods by instalments where title in the goods does not pass until the final instalment is paid.''

There is no general definition of the term "lease" for income tax purposes and while the common law meaning of "lease" probably only applies to real estate transactions the term is commonly used to describe bailment of chattels for consideration. In practice, the only way to tell the difference between a lease agreement and hire purchase agreement is to read the terms and conditions of the agreement. The ATO considers a finance agreement to be a lease when:

- there is no option to purchase the vehicle written into the agreement; and
- the residual value reflects a bona fide estimate of the vehicle's market value at the end of the lease period.

If these 2 conditions are not met, the ATO considers the agreement to be a hire purchase or chattel mortgage agreement and therefore only the interest component of the payments is deductible (plus depreciation). Whereas, if the product is a lease the full amount of the monthly rental is deductible under s 8-1 ITAA 97 (if the equipment is used for income-producing purposes).

For income tax purposes the tax treatment of hire purchase and chattel mortgage products will usually be the same. However, in our opinion this is not true for GST purposes. This conclusion turns on the fact that there is a significant legal distinction between the two products. Title to the goods under a chattel mortgage facility usually passes to the purchaser of the goods when they are delivered to the purchaser. The financier never owns the goods; it simply has a security interest in the goods (chattel mortgage). In contrast, with a hire purchase facility title to the goods rests with the financier until the final payment is made. Once the goods have been fully paid for, title passes from the financier to the purchaser. This distinction becomes important

when analysing the GST treatment of these two products.

Table A summarises the differences from an income tax perspective.

GST TREATMENT OF LEASE AGREEMENT

A lease agreement grants a lessee use of plant or equipment owned by the financier for the term of the lease agreement. The financier remains the owner of the equipment. The lessee pays the financier a lease rental and usually guarantees that the equipment will be worth the agreed residual value at the end of the lease period.

Where the financier is registered for GST the supply of the equipment by way of lease will usually be a taxable supply. Where a lessee is registered for GST it will be entitled to claim a corresponding input tax credit if the lease rental is a creditable acquisition. If the lessee purchases the equipment at the end of the lease (usually at a price equal to the residual value), this will be a separate supply and will also be subject to GST if the supply is a taxable supply.

There are potentially two supplies being made: a one off grant of the lease and sale of the equipment at the end of the lease.

Case study (cont.)

Assume Colin chooses to finance the new vehicle by way of a lease agreement. The old vehicle is sold for $16,500 and the new vehicle costs $44,000. The finance company quotes a monthly rental of $1,100 over a term of 5 years with a 30 per cent residual.

Cash basis taxpayer

Where a lessee is registered for GST on a cash basis the taxpayer will be entitled to claim an input tax credit for the monthly lease rental in the tax period in which the rental is paid.

On these facts, Colin will have a GST liability of $1,500 in the tax period in which he disposes of the old vehicle (this is true even if the old vehicle was acquired pre-GST) and he will be entitled to claim an input tax credit of $100 per month for 60 months. If Colin purchases the vehicle at the residual value of $13,200 at the end of the lease he will be entitled to a further input tax credit of $1,200 in that tax period.

TABLE A

	Ownership	Income tax treatment
Finance Lease	The financier is the owner of the goods. The lessee guarantees the residual value upon expiry of the lease and will usually make an offer to buy the goods at the residual value upon completion of the lease.	Lease rentals are generally deductible under s 8-1 ITAA 97 in the period in which the rental is incurred
Hire Purchase	Title remains with the vendor of the goods or the financier until the last rental payment is made.	Div 240 ITAA 97 recharacterises the transaction as being a sale of property (on credit terms) to the hirer at the time of the arrangement. This legal fiction allows the hirer to claim the interest expense and depreciation on goods that it notionally owns.
Chattel Mortgage	Title passes to the purchaser of the goods (usually) upon delivery. The financier has a charge over the goods to secure the loan made to finance the acquisition.	Interest on the loan is deductible under s 8-1 ITAA 97. Depreciation can be claimed under the Uniform Capital Allowance rules.

Non-cash taxpayer

Ordinarily the lessee would be entitled to claim an input tax credit on the whole of the consideration payable on the grant of the lease upfront because this is a single supply of goods by way of a single lease agreement. However, the div 156 (progressive or periodic supplies) provisions of the GST Act catch this transaction. This means that a taxpayer who is registered for GST on a non-cash basis must attribute the input tax credit to the period in which the lease rental is due to be paid (note this might be a tax period other than the tax period in which the liability is actually discharged).

GST TREATMENT OF HIRE PURCHASE CONTRACTS

Under a hire purchase contract the hirer has the use of the equipment while he is paying for it under an installment plan. The financier owns the equipment until the last installment is paid. At that point in time the hirer becomes the owner of the equipment.

It is not clear to us how a literal interpretation of the law would treat this transaction. Arguably, the supply being made under the hire purchase transaction is similar to that under a lease agreement. That is two supplies are made: the financier first grants the hirer the right to use certain equipment for a period, but also agrees to transfer ownership of the equipment to the hirer upon payment of the last month's rental.

However, the Commissioner has said in GSTR 2000/35 that "a hire purchase agreement is in commercial substance a method by which the 'hirer' purchases goods on deferred payment terms [therefore] it is not a supply progressively or for a period".[2] He goes on to say that this is so because while the transaction is technically a bailment, with an option to purchase, the intention of the parties is that the goods will never be returned to the financier. While this GST ruling does not go on to draw any conclusions as to what this means about the attribution of GST liability the ATO's "Hire purchase, leasing and GST – Fact Sheet" advises that the correct treatment of a hire purchase transaction requires the GST attribution to follow the commercial substance of the transaction, rather than its legal form. As this assertion is favourable to the taxpayer, and is consistent with the income tax law, we will not object to the Commissioner's interpretation.

However, another issue arises in regard to hire purchase. On the commercial substance view of a hire purchase transaction the hire purchase rental amount is a function of the term of the contract and the interest rate payable on the arrangement. This means that we need to consider the GST treatment of the notional interest component of each rental payment. Interest payments represent the consideration payable for the supply of money. A supply of money in these circumstances would be an input taxed

financial supply therefore GST will not usually be attributable to that part of the hire purchase rental. However, where the amount of interest payable under a hire purchase agreement is not separately identified and disclosed to the hirer the total amount payable under the contract will be subject to GST.[3]

As the hirer ends up owning the equipment there is no residual payment as such, however, the last rental payment may be a lump sum balloon amount similar to the amount typically payable as the residual value on a lease agreement.

Case study (cont.)

Assume Colin chooses to finance the new vehicle by way of a hire purchase agreement. The old vehicle is sold for $16,500. He takes $10,000 in cash to repay some business debts and contributes $6,500 as a trade-in against the purchase price of the new vehicle (costing $44,000), therefore Colin has to finance $37,500. The finance company quotes a rental of $770 per month for a term of 5 years. This amount represents repayment of the $37,500 net purchase price plus interest of $8,700.

Cash basis taxpayer

On these facts Colin will be liable for $1,500 GST on the disposal of the vehicle and he will be entitled to claim an input tax credit of $590 in the first tax period and approximately $57 on each monthly payment of $770.

The input tax credit of $590 represents one eleventh of the value of the $6,500 trade-in allowance (this amount being part payment of the purchase price). If Colin had allowed 100 per cent of the trade-in value to be credited towards the purchase price of his new vehicle the input tax credit on this part of the transaction would match the liability that accrued because of the disposal.

As the financier has separately advised the interest component of the monthly rental (18.8 per cent of the total amount payable under the contract) the input tax credit on the monthly rental payment is reduced by $13 per month. Note: the monthly interest cost of $145 in this example is calculated on a simple straight-line basis. In our opinion, if the financier has not separately identified the amount of interest payable on each monthly installment (ie: the financier simply advised the interest payable as a lump sum) it would be open to Colin to calculate the interest on a credit foncier basis. However, as this method attributes a higher interest amount to the earlier payments, the credit foncier method would have the effect of reducing the input tax credit in the early days of the finance agreement.

Non-cash taxpayer

Because the Commissioner is of the view that GST should be attributed on the basis of the commercial substance of the transaction it follows that if Colin was a non-cash taxpayer he would be immediately entitled to claim an input tax credit on the full purchase price of the equipment. This is because the commercial substance approach assumes that Colin borrowed the purchase price and acquired the property at the beginning of the transaction.

Therefore, on these facts the Commissioner accepts that while Colin would still be liable for $1,500 in GST on the disposal he would have the immediate benefit of a $4,000 input tax credit.

GST TREATMENT OF CHATTEL MORTGAGE FACILITIES

Under a chattel mortgage facility there is no need for a substance over form analysis. This is because the legal form of the transaction is that the end user arranges a loan from a financier, uses this loan to acquire the goods and then grants the financier a charge over the equipment to secure the loan.

This means that there are two supplies. A financial supply of money by the financier and a supply of the equipment by the vendor of the goods.

Case study (cont.)

Assume the same facts as the previous case study except that Colin chooses a chattel mortgage instead of a hire purchase contract and he provides a deposit of $22,000 (partially by way of the trade-in and partially in cash).

Cash basis taxpayer

On these amended facts Colin will still be liable for $1,500 in GST on the disposal of the old vehicle but even though he is a cash based taxpayer he would have the immediate benefit of a $4,000 input tax credit. This is because he has used the separate finance facility to pay for the vehicle in full in the tax period in which he took delivery of the vehicle. The amount of Colin's deposit becomes irrelevant.

As with other finance facilities made available to Colin's business the loan supplied by the financier will be an input taxed financial supply.

Non-cash taxpayer

When a chattel mortgage facility is used both a cash and non-cash taxpayer will be treated the same as there is no timing difference that needs to be adjusted for. Interpretative Decisions 2001/727 and 2001/728 support this conclusion. As long as the registered taxpayer holds a tax invoice he will be entitled to claim a $4,000 input tax credit under s 29–10 of the GST Act.

CONCLUSION

Everything else being equal:

- Where a client is registered for GST on a cash basis there is an obvious tax and cash flow benefit in using a chattel mortgage facility over either a hire purchase or lease facility.
- If a client is registered for GST on a non-cash basis their best choice would be to use a hire purchase contract on which the financier does not separately identify the interest cost. This is because this product will allow the hirer to claim an input tax credit on the interest component of the transaction. However, as these products are not commonly available[4] non-cash clients would usually receive the best long-term outcome from a leasing because this product also allows the lessee to claim input tax credits on the interest component of the rental amount.[5]
- Where the short-term cash flow impact of obtaining the input tax credit is important to a client who is registered for GST on a non-cash basis either a hire purchase or chattel mortgage facility will provide the best result. ◆

Keith Harvey, Ambry Legal, Melbourne
George Kolliou, McGrath Kolliou & Associates

Reference Notes

1 *"The Tax Agent", national ATO tax agent newsletter, Issue 1, September 1998*
2 *para 66 of GSTR 2000/35*
3 *Not that we have ever seen a hire purchase contract that doesn't break out the interest cost.*
4 *If only because of the Consumer Credit Code.*
5 *However, everything else is not equal. Where a lessee obtains a GST benefit the lessor will usually suffer a cost. This cost will usually be factored into the lease rental amount*