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The Board of Taxation

Review of the Legal Framework for the Administration of the Goods and Services Tax

Executive Summary

This submission is made on behalf of members of the Australian Finance Conference, Australian Equipment Lessors Association, and Australian Fleet Lessors Association, membership lists attached.

Our principal concern is the distortion of the equipment finance market as a result of the GST treatment of hire purchase arrangements. Because hire purchase is not treated on its legal substance, cash flow taxpayers are opting for chattel mortgage, increasing risks and costs in this market segment. Other comparable jurisdictions have introduced special rules to ensure this distinction does not arise. Cash basis taxpayers under hire purchase arrangements should be entitled to input tax credits upfront, to correspond with the GST treatment under chattel mortgage arrangements.

The submission makes recommendations on a range of other issues to enhance the efficiency and equity of the administration of GST.

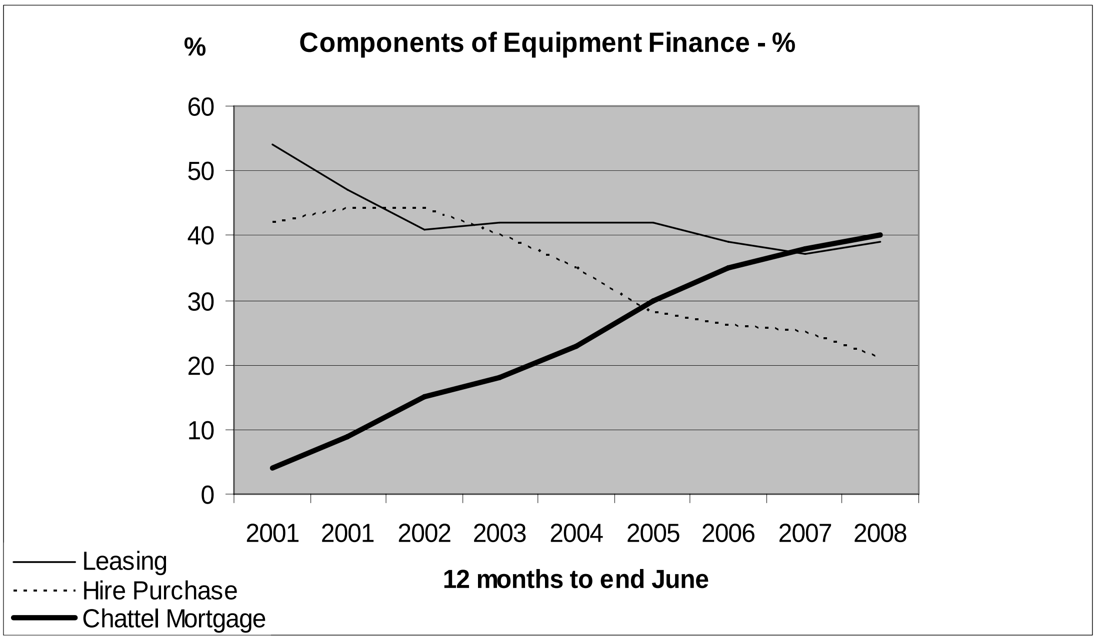
Suggestions are also made in relation to the GST review process, including an annual review of the international competitiveness of our GST system and a further GST review in three years.

Although outside the scope of the Review, the submission also suggests the adoption of zero-rating, or GST free treatment of financial services, in the event that the Board may see merit in recommending that the Government give consideration to this reform.

1. Hire purchase arrangements and cash basis taxpayers

The GST treatment of cash basis taxpayers under hire purchase arrangements is distorting the equipment finance market, causing a major shift to chattel mortgage that would not otherwise occur. Equipment finance is a $40 billion per annum market, with financiers providing three basic products: leasing, hire purchase and chattel mortgage.

GST cash basis taxpayers under hire purchase arrangements cannot claim input tax credits upfront, but can only claim them over the life of the agreement. Not surprisingly, those customers are opting for chattel mortgage, enabling them to claim the input tax credit immediately.



Chattel mortgage was largely unused prior to GST, but as a direct consequence of this distortion now accounts for forty percent of equipment finance.

Of the three products, chattel mortgage has the highest costs and risks (outlined below). It is well accepted that tax distortions which adversely impact on commercial decisions should be addressed. For example, the Explanatory Memorandum to the TOFA proposals noted:

> *"One of the basic objectives guiding the reforms to the taxation of financial arrangements is to improve the level of tax neutrality, that is, to remove, as far as possible, adverse effects of taxation on commercial decision-making by reducing the extent of tax-induced distortions. Such distortions impact adversely on pricing, the allocation of investment activity, risk management and the general efficiency and effectiveness of capital markets."*

This distortion would not arise if the GST treatment of hire purchase was consistent with its legal substance, which is a hire of goods with an option to purchase. It is therefore a supply of rights to use the goods for a period and the supply of a right to purchase the goods at or before the end of the period. If this legal substance was followed, Division 156 of the GST Act would apply, and the GST payable and input tax credits on the supply or acquisition would be attributable as if each progressive or periodic component of the supply were a separate supply. Accordingly, cash basis taxpayers would not suffer a GST cash flow disadvantage.

Rather than follow the legal substance for GST purposes, the Tax Office has opted to treat hire purchase as a supply of goods and a separate supply of finance. The adoption of this 'sale and loan' approach has required special Tax Office rules to address 'inappropriate outcomes' that arise (for example, for the purpose of Division 105, which deals with supplies in satisfaction of debts, the Tax Office requires that hire purchase be treated on its legal substance, with the financier's legal status as owner of the goods to apply). But, in Australia, rules have not been introduced to remove the distorting effect on commercial decision making resulting from the Tax Office approach.

Other GST/VAT countries have in fact introduced special rules to ensure that this distortion does not arise. We have attached a KPMG report on the comparative jurisdictions of the U.K., New Zealand and South Africa, which concludes that only in Australia is a cash basis taxpayer not entitled to an input tax credit for the whole of the VAT/GST payable under the hire purchase agreement in the tax period that corresponds to the taking up the hire purchase.

Overcoming this distortion

One approach for overcoming this distortion is provided by section 29-25 of the GST Act, under which the Commissioner has the discretion to specify a different tax period to that which would otherwise apply if satisfied that the application of the basic attribution rules produces an inappropriate result. We believe the Commissioner has ample reason to exercise this discretion, as this distortion is a direct consequence of the Tax Office's action in adopting a GST treatment of hire purchase which does not follow its legal substance. The exercise of this discretion would ensure that cash basis taxpayers would be put on the same footing as accruals basis, and enabled to claim input tax credits upfront; this would correspond with the position of cash basis taxpayers under chattel mortgage arrangements.

Increased costs and risk of chattel mortgages

This distortion is having adverse impacts on commercial decision-making, by increasing both costs and risks. Costs are increased by the additional administrative tasks required for chattel mortgages:

- chattel mortgage documents must be prepared in duplicate or triplicate, and scanned if lodging electronically with ASIC;
- an ASIC lodgement fee of $135 is payable;

- a Form 309/350 Registration of Charges document must be prepared and lodged;
- search costs are incurred to determine if the borrower has granted a fixed or floating charge to another financier;
- written acknowledgement is required from the fixed/floating charge holder to exclude the asset under the chattel mortgage from that charge;
- a Form 312 Release of Charge must be prepared and lodged with ASIC at the termination of the chattel mortgage.

These requirements apply where the customer is a company; different but similarly cumbersome requirements apply for sole traders and partnerships. None of these requirements apply for lease or hire purchase arrangements, and there are no additional requirements of this nature that do apply to these products. The additional requirements for chattel mortgage apply because the financier is taking security over the asset, whereas under lease and hire purchase arrangements the financier is the owner.

This distinction is also the basis of the increased risks of a chattel mortgage; the financier may find it is commercially uneconomic to adopt all of these procedures, or some may be completed in a manner that could subsequently be challenged in a court. A further risk factor is the question of priority between the ASIC company charges register and the Motor Vehicle Security registers which are state-based. This increased cost/risk profile of the chattel mortgage product makes it the worst of the three equipment finance options for both the borrower and the financier.

Clarification of our submission on cash basis taxpayers under hire purchase arrangements

- We are not suggesting that the GST treatment should be tailored to increase the market share of hire purchase. Our submission is that the current treatment is a tax-induced distortion which is impacting adversely on pricing, risk management and the effectiveness of capital markets.

- In drawing together the treatment in comparable GST/VAT jurisdictions, we are illustrating that all like overseas regimes have recognised that this is a distortion, and have made special rules/adjustments to address this distortion.

- We are not seeking to ease the cash flow burden for some businesses. Cash basis taxpayers do not have a cash flow burden, as they are using the chattel mortgage product; our objective is to redress the inefficiency and additional risk resulting from a taxation distortion.

- It is appreciated that these GST arrangements have been in place for eight years, and the equipment finance market continues to function. However, it is the role of tax reform to address such tax-induced distortions, because of their adverse impact on risk, allocation and efficiency. For example, the fact that stamp duties on financial arrangements were in place for many years does not diminish the importance of the continuing reforms to abolish these duties.

- We do not seek a change to the GST law generally as it applies to cash basis taxpayers. Rather we are seeking a very limited and targeted measure.

- We have noted that one way to remedy this distortion is for the Commissioner of Taxation to make a determination under subsection 29-25(2) of the GST Act. This has been suggested as an efficient way, but if this mechanism is regarded as not being appropriate, we submit the distortion is sufficiently material to warrant an alternative resolution.

2. Other GST Issues

a) GST grouping

Our members have identified two problems with the grouping provisions: firstly, an entity can only group from the first day of the month, and secondly, an entity cannot group from the date of registration (as it will not have an ABN at that time).

We suggest that it should be possible for an entity to be able to group from any date. For larger corporates, it is a common event to register new entities. It is often the preference to group new entities from day one, but current Tax Office requirements preclude this. We suggest that an election to group should be an option within the registration process.

b) Agent and principal – transferring the GST liability and input tax credit entitlement to the agent/intermediary

The Australian GST regime has attempted to mitigate some of the adverse consequences of a strict adherence to principal and agency requirements by way of section 153B. But it is suggested that this section is cumbersome and inflexible, and should be substantially relaxed to permit the intermediary/agent to solely account for GST and to claim input tax credits, as in many cases they will have the best information to do so. That is, the principal could elect, with the agreement of the intermediary, to transfer its GST obligations and entitlements to the intermediary in a less restrictive manner than at present. In particular:

- in relation to both acquisitions and supplies, where there is eligibility for full input tax credits, we suggest there should not be a requirement for an exact back-to-back on-charge. There should be no requirement for the principal/intermediary to make an on-charge, but if an on-charge is made (whether exact or not) it should continue to be a deemed taxable supply between principal/intermediary;
- on the supply side, where the customer is not entitled to a full input tax credit, in relation to the underlying principal's supply it should be sufficient that the intermediary make a minimum taxable supply of the amount the principal would have made had the transfer of the GST liability not occurred;

- on the acquisition side, a more flexible approach to specifically naming the acquisitions for which an intermediary seeks to claim the input tax credit should be devised;
- that it be possible for the intermediary to obtain a representation from the recipient principal (on the acquisition side) as to full input tax credit entitlement, or for the intermediary to make a reasonable assessment that the recipient would have been entitled to a full input tax credit. Similarly, on the sale side, that it be possible for the intermediary to obtain a representation from the customer as to full input tax credit entitlement or to make a reasonable assessment of such.

c) General interest charge

Members consider it is unfair that a business can be penalised for both the shortfall interest charge (SIC) and the general interest charge (GIC) in circumstances where the result for the revenue is neutral. If there has been a careless error that results in no revenue loss our members suggest the SIC is the appropriate mechanism.

In addition, we believe the ATO should be required to consider all overpayments and underpayments in a given tax period, and only be able to impose penalties on net underpayments.

In a similar vein, it is suggested that the Tax Office should be required to consider the overall revenue impact of an error, rather than base penalties on technicalities and isolated events. For example, a taxpayer is assessed for underpaid GST, but at the same time has an equivalent credit pending that, but for a technicality, could have been claimed in the same period to which the assessment relates. In an economic sense, one offsets the other, and a penalty should not be imposed.

d) Period of review of refunds

It is suggested that the refund review period should be limited to four years from the tax period to which the GST on the relevant taxable supply was attributed.

e) Accounting rules

The current rules allow for the use of accounting month ends provided they are within seven days of the beginning or end of the month. However, there may be situations, for example year-end, where a taxpayer is required to perform a 'hard close' more than seven days before the end of the month. It would be beneficial if taxpayers could close their books early and estimate for the remainder of the month, and perform reconciliations the following month.

f) Apportionment

i) Revenue method

It would be helpful if the revenue method of apportionment (refer GSTR 2006/3) was legislated. The objective of this request is to provide certainty for both the Tax Office and taxpayers, and ensure consistency within and between industries that make input taxed supplies and mixed supplies.

ii) Adjustments

Any chosen apportionment method will make reference to the underlying taxable and input taxed supplies. The relative contribution of taxable to input taxed supplies will change from year to year, which in turn will give rise to adjustments to the GST liability for the relevant period. It is suggested that taxpayers should be able to make a retrospective adjustment to a BAS return arising from a change in the taxable/input taxed ratio, within six months of the relevant BAS.

g) Barter transactions

It is suggested that taxpayers can elect to zero-rate barter supplies where both barter supplies are taxable and both entities have full input tax credit entitlements in relation to those supplies.

h) Hire purchase attribution

As noted above, the Tax Office has not opted to treat hire purchase for GST purposes on the basis of its legal substance, and this has caused numerous difficulties.

It has been suggested by a number of our members that the GST treatment of hire purchase should be prospectively changed to reflect the fact that it is a hire of goods with an option to purchase. For GST purposes it would then be treated the same as a lease, and would eliminate many of the complexities surrounding the existing rules.

Ideally, item 8 in regulation 40-5.09 of the GST Regulations would be deleted, such that the full rental is subject to GST. This should not be an issue, as our members have advised that in excess of ninety-five percent of hire purchase agreements have been entered into with businesses.

It should be noted that this suggestion would require significant systems changes. There are also other aspects which require full investigation, and accordingly we believe that this issue would require further consideration before it was implemented.

i) Establish a 'permanent' LCT quoting mechanism

The maximum period a wholesale purchaser can quote a wholesale seller of luxury cars is one year. The need to annually refresh LCT quoting is tedious and time consuming, and can commence up to two months prior to renewal date as wholesale buyers are tracked down prior to deadline to provide the annual quote. There is also a risk that an annual quote inadvertently fails to be renewed.

It is suggested that a 'permanent' LCT quoting mechanism be established, obviating the need for annual renewals and the buyer be only permitted to withdraw this 'permanent' LCT quote by giving written notice that it no longer applies to all vehicles purchases by that buyer.

If a ‘permanent’ LCT quoting mechanism is not acceptable, as an alternative the maximum periodic quoting period be extended to five years.

j) Election to over-ride accruals accounting where vendor and purchaser agree

For an entity accounting for GST on an accrual basis, the GST liability and input tax credit entitlement arises at the earlier of when an invoice is issued or any part of the consideration is received. While this is a fundamental GST rule, it can create substantial cash-flow impacts on the vendor.

This could be overcome at no revenue cost by establishing an elective regime where vendor and purchaser (who both account on an accruals basis) can opt to treat a specific transaction(s) on the cash basis.

k) Simplification/relaxation of Division 129 ‘change of use’ adjustments

The Division 129 change of use machinery is very complex and involves considerable compliance costs. Suggested possible reform measures are:

- substantially increase the acquisition thresholds;
- substantially reduce the number of adjustment periods in the scale (suggested the maximum should be four and not ten).

Our members have emphasised that this is a particularly important issue, with the limits being totally unrealistic from a commercial point of view, and the adjustment periods similarly excessive. It is suggested that the number or review periods should not, logically, exceed the GST audit period of four years; and that the Division should be limited to the acquisition of goods and real property above, for example, a threshold of $500,000.

l) Technical timing breaches

There is a risk of non-compliance for an accruals basis taxpayer if systems constraints prevent the correct time of recognition of a GST liability. For example, ‘an invoice’ may be issued very late in the month, but system constraints result in the recognition of the GST liability in the next month. It is suggested that the Commissioner be required to exercise discretion and permit the technical breach in cut-off to continue (without GIC or penalty) where the taxpayer is on a monthly BAS cycle.

m) Elective to over-ride GST grouping principles where vendor principal is selling to a group member via an intermediary

It is possible for a business arrangement to involve a vendor principal, an intermediary of the vendor principal (but not grouped with the vendor), and a customer of the vendor principal grouped with the vendor principal.

For current GST purposes intra-group supplies are disregarded. However, it may in some cases be more efficient and easier from a systems perspective for the intermediary to elect to treat the supplies as taxable and for the customer to treat these as taxable supplies from the intermediary.

n) Tax Office advice of changes to Luxury Car Tax threshold

The luxury car tax (LCT) threshold is currently $57180, and is reviewed annually in line with movements in the motor vehicle sub-group of the Consumer Price Index (CPI), and calculated on the basis of the March quarter CPI. The March quarter CPI is usually released in May, but in recent years the Commissioner has not advised the limit for the new financial year until the very last few days of June. We recommend that the Commissioner undertake to provide this advice no later than three weeks from the publication of the March quarter CPI.

o) Sales by mortgagees and liquidators

We believe there is an unintended consequence where a mortgagee, liquidator, etc sells property over which it has rights because of default by the mortgagor. The mortgagee/liquidator becomes liable to pay the GST on the sale of the property. We suggest the appropriate GST outcome is for such liability to remain with the mortgagor/debtor, so that the GST outcome would be the same irrespective of whether it is the mortgagor or mortgagee/liquidator who sells the property.

p) Clarification of a ‘non-disclosed’ hire purchase

For GST purposes there are two types of hire purchase agreements, broadly referred to as ‘disclosed’ and ‘non-disclosed’. Where no separate credit charge is disclosed to the customer the hire purchase is treated as a fully taxable supply, and the financier is liable for GST on all charges under the agreement and entitled to input tax credits on all acquisitions required to make that supply. Non-disclosed hire purchase has not been used widely, and uncertainty remains as to the nature of a non-disclosed hire purchase. Accordingly, Tax Office clarification as to what constitutes a ‘non-disclosed’ hire purchase arrangement for GST purposes would be appreciated.

q) Other recommendations

There have been a substantial number of issues and recommendations made to the Board in the initial consultation stage. Our members note their support for the following issues in particular, which in some respects overlap with the issues raised above:

- the form and content rules for adjustment notes need to be materially relaxed;
- the form and content requirements for tax invoices should be relaxed;
- the Commissioner should be legislatively prohibited from imposing GIC and penalty in ‘wash transactions’;
- the recipient created tax invoice rules should be relaxed, including having the agreement for their use recorded on the face of the RCTI and not in a separate agreement;
- improved rules to provide more certainty around entering and exiting a GST group;
- that the current rule enabling a taxpayer to claim an input tax credit in any ‘subsequent period’ be retained;
- the Commissioner’s current thresholds for correcting past mistakes in the current BAS are far too restrictive, and the thresholds need to increase substantially in recognition that GST is a difficult tax

and taxpayers have very challenging obligations and risks in collecting this tax for government;

- the scope of 'reviewable indirect tax decisions' be enlarged to include remission of GIC;
- the imposition of GIC at its very high and daily compounding rate is unreasonable in the GST context and requires reform.

3. GST review process

Members suggest there is an immediate need to ensure that the GST review process produces meaningful improvements in the administration of GST, and that a process be put in place to deliver ongoing reforms. To this effect, we recommend the following:

a) Medium-term efficiency dividend

It is acknowledged that the Review's terms of reference require the outcomes to be 'broadly revenue neutral'. It is submitted that the Review should take a broad and dynamic interpretation of this limitation, recognising that a more efficient and internationally competitive GST regime would, amongst other things, enhance GST revenue in the medium term.

b) An ongoing annual report on the relative competitiveness of our GST system.

Internationalisation of economies and rapid technological advance are key aspects of commercial life. Australia has an opportunity to become an international financial hub, and competes with overseas economies to attract international investment and transactions.

It is recommended that the Commonwealth establish a small secretariat that on an annual basis reviews GST/VAT developments in other jurisdictions, and produces an annual report that makes recommendations on how the Australian GST regime can be made more competitive and less compliance cost intensive.

c) Follow-up review in three years

It is suggested that a follow-up GST review be conducted by the Board of Taxation in three years. This would provide an audit of the implementation of the recommendations of this Review, and take account of the relative competitiveness of our regime in light of international developments.

4. Zero-rating of financial services

Although outside the Review's terms of reference, we would like to raise the issue of zero-rating (or GST free) treatment of financial services, in the event that the Review may see merit in recommending that the Government give consideration to this reform.

The GST treatment of financial services has always presented a challenge, but when introduced in Australia our approach was equal to or better than comparable GST/VAT jurisdictions. In the meantime, there has been much debate and the general consensus is that zero-rating of financial services is the most effective approach in addressing the inefficiencies of input taxation. The Australian approach is now inferior, particularly compared to approaches taken by GST jurisdictions in our local region. If Australia's financial system is to remain competitive in our region, close consideration needs to be given to the introduction of zero-rating of financial services. If such reform is regarded as initially too far-reaching, it could be approached in a two-stage process, commencing with zero-rating of B2B financial services.

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AFC MEMBER COMPANIES

Adelaide Bank AllCommercial Finance Alleasing American Express Australian Finance Direct Australian Motor Finance Bank of Queensland BankWest Bidgee Finance BMW Australia Finance Capital Finance Australia Caterpillar Finance Australia CBFC Centrepoint Alliance CIT Group Citigroup CNH Capital Collection House Credit Corp Group De Lage Landen Dun & Bradstreet Enterprise Finance Solutions Esanda Finance Corporation Flexirent Capital Ford Credit FundCorp GE Commercial GE Money Genworth Financial GMAC Hanover Group HP Financial Services HSBC Bank Indigenous Business Australia Integrated Asset Management International Acceptance John Deere Credit Key Equipment Finance Komatsu Corporate Finance Leasewise Australia Liberty Financial Lombard Finance	Mackay Permanent Building Society Macquarie Equipment Rentals Macquarie Leasing Max Recovery Australia Members Equity Bank Mercedes-Benz Financial Services MotorOne Group PACCAR Financial Profinance RABO Equipment Finance RAC Finance RACV Finance Retail Ease Ricoh Finance Service Finance Corporation Sharp Finance SME Commercial Finance St. George Bank Suncorp Suttons Motors Finance The Rock Building Society Toyota Financial Services UFS Group Veda Advantage Volkswagen Financial Services Volvo Finance Westlawn Finance Westpac Wide Bay Australia Yamaha Finance <u>Professional Associate Members</u>: Allens Arthur Robinson Australian Business Research Bartier Perry CHP Consulting Clayton Utz Corrs Chambers Westgarth FCS Online Finzsoft Solutions Henry Davis York 07/08

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Our ref 1322-AELA04-0208-L-HPCreditDAJ0331-MTL1.doc
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2 August 2004

Dear John

International treatment of hire purchase credit entitlements

You have sought our advice concerning the Value Added Tax ("VAT") and Goods and Services Tax ("GST") treatment of acquisitions of goods under hire purchase agreements for taxpayers who account on a cash basis, in the United Kingdom ("UK"), New Zealand and South Africa.

The VAT / GST rules that govern the accounting for VAT and GST for hire purchase agreements in each jurisdiction are described hereunder, together with a comparison with the Australian GST rules.

Executive Summary

In Australia, the UK, NZ and South Africa, the VAT and GST regimes contain special rules that allow some taxpayers to account for VAT and GST on a cash basis. The UK, New Zealand and South Africa have specific rules that apply to the accounting for hire purchase agreements.

Of these comparative jurisdictions, only in Australia is a cash basis taxpayer not entitled to an input tax credit for the whole of the VAT / GST payable under the hire purchase agreement in the tax period that corresponds to the taking up of the hire purchase.

We consider that the GST applies inappropriately, if it operates for a cash basis purchaser, to spread the input tax credit for GST payable under the hire purchase agreement in proportion to the payments made under the agreement. As such, the Commissioner of Taxation is able to make a determination under subsection 29-25(2) of the *A New Tax System (Goods and Services Tax) Act 1999* ("GST Act") to remedy the defect and, in our view, is legally bound to do so to prevent the attribution provisions of the GST law applying in a way that is inappropriate to cash basis hirers.

International VAT / GST comparison

Australian GST law

Definition of hire purchase

For Australian GST purposes, while the term 'hire purchase agreement' is defined (through section 195-1 of the GST Act) as having the meaning given by section 995-1 of *the Income Tax Assessment Act 1997* ("ITAA 97")[1], the GST Act itself does not make any reference to a "hire purchase agreement".

In his ruling dealing with accounting for GST (GSTR 2000/29) the Commissioner states that a hire purchase agreement has the following key features:

- hiring charges are calculated to cover the cash price of the goods plus credit charges, delivery, insurance etc, less any cash deposit or trade in; and

- the recipient takes possession of the goods, and has a right to use the goods, as well as an option to buy the goods, exercisable at or before the end of the hire period.

Agreements for the purchase of goods by instalments where title in the goods does not pass until the final instalment is paid are also regarded as hire purchase agreements[2].

GST treatment of hire purchase – value of supply

Essentially, the GST Regulations operate to exempt from GST any separate credit charge disclosed under a hire purchase agreement (refer item 8, subregulation 40-5.09(3)).

The credit component is an "input taxed" supply, having the consequence that, while GST is not payable on the disclosed credit charge, the supplier is not entitled to input tax credits for acquisitions made by it to the extent that the acquisition relates to the supply of credit under the hire purchase agreement.

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[1] The term "hire purchase agreement" in the ITAA 97 means:

(a) a contract for the hire of goods where:

(i) the hirer has the right, obligation or contingent 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 and 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 referred to in subparagraph (a)(i) 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.

[2] See, eg, paragraph 191 of GSTR 2000/29 and section 74D Stamp Duties Act (NSW) 1920.

The remaining component of the hire charges are GST taxable having the result that the financier is liable to pay GST of 1/11th of the hire charges less the disclosed credit component (referred to hereafter as the "cash component").

GST treatment of hire purchase – time of supply – general rules

The Australian GST law operates to "attribute" GST payable on a supply to particular tax periods. The GST attributable to that period must be accounted for in the GST return covering the period.

We have assumed that financiers will have monthly tax period and account for GST on a non-cash (accruals) basis.

Broadly speaking, the Australian "attribution" rules play the same function as what are referred to as the "time of supply" rules in foreign VAT and GST jurisdictions.

Under the general attribution rules contained in section 29-5 of the GST Act, the GST payable on the cash component of a hire purchase agreement is attributable to the tax period in which the earlier of the following occurs:

- issuing an invoice for the supply; or
- receiving any consideration for the supply.

This will generally be the tax period during which the hire purchase agreement is entered into[3].

For hirers, the attribution rules in section 29-10 of the GST Act apply. Accruals basis hirers are then entitled to the full input tax credit for the GST payable on the supply in the tax period in which the earlier of the following occurs:

- an invoice is issued for the supply; or
- any consideration is provided for the supply.

This will generally be the tax period during which the hire purchase agreement is entered into.[4] However, the hirer will only be able to claim an input tax credit if a valid tax invoice is held.

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[3] The Commissioner, in GSTR 2000/29, states that Division 156 of the GST Act does not apply to a supply or acquisition made under hire purchase agreements because it is not a "periodic supply".

[4] See 3 above.

For hirers who account for GST on a cash basis however, the situation is different. A GST registered entity that accounts for GST on a cash basis is only entitled to claim an input tax credit to the extent that it has provided the consideration for the supply. Therefore a cash basis hirer is only entitled to an input tax credit of $1/11^{th}$ of the payments of the cash component as and when it is made to the financier.

Variation of the "attribution rules"

The GST Act allows the Commissioner to determine that GST payable and input tax credits will be "attributable" to different periods if he is satisfied that the determination is necessary to prevent the GST law operating inappropriately. The relevant subsection (29-25(2)) authorises the Commissioner to make a determination in the case of a hire purchase agreement (paragraph 29-25(2)(a)).

In his ruling dealing with this matter (GSTR 2000/29), the Commissioner has stated, at paragraph 214:

> "The basic attribution rules provide the same outcome for a supply and acquisition of goods under a hire purchase agreement as results from the application of the basic attribution rules to the supply of goods by way of sale. This outcome is consistent with the income tax treatment of hire purchase agreements. The Commissioner is not satisfied that the application of the basic attribution rules in relation to hire purchase agreements is inappropriate."

The Commissioner argues that the basic attribution rules achieve the same result as if the hire purchase agreement were the sale of goods. It does not, however, recognise that the GST law also treats a "disclosed credit charge" hire purchase agreement as a financial supply. So, it would be more correct to equate such a hire purchase agreement with a sale of goods that is financed by a loan.

In our view, the basic attribution rules are inappropriate in the case of a "disclosed credit charge" hire purchase agreement because they do not recognise a full input tax credit entitlement of the hirer at the time the goods are "sold" and the finance arrangement entered into.

The lack of neutrality in this respect (between a sale financed by chattel mortgage and a "disclosed credit charge" hire purchase agreement) makes the application of the basic attribution rules inappropriate such that the Commissioner is bound, in our view, to make a determination to prevent the inconsistency occurring.

Evidence that the existing rules are inappropriate can be found in the bias of cash basis purchasers in the market place against hire purchase agreements, such that cash basis customers will turn to other forms of financing.

UK VAT law

In the UK, the VAT regime is governed by the *Value Added Tax Act 1994* ("VAT Act") and the collection and control of VAT is the responsibility of HM Customs and Excise ("Customs").

While taxpayers utilising the cash accounting scheme are generally only able to claim the VAT paid to the extent of the payments actually made, there is a special provision within the *Value Added Tax Regulations 1995* ("VAT Regulations") which makes an exception for goods purchased under a hire purchase agreement.

Subregulation 58(2)(b) of the VAT Regulations specifically excludes hire purchase agreements from the cash accounting scheme. To further explain the exclusion, paragraph 2.3 of VAT Notice 731 states:

> "The transactions below are excluded from cash accounting both to simplify the scheme and assist the cash flow of small businesses:
>
> - goods that you buy or sell under lease purchase, hire purchase, conditional sale or credit sale agreements..."

Consequently, in the UK, due to this specific exclusion, hirers who account for VAT on a cash basis are able to deduct the whole amount of the equivalent of the input tax credit for the VAT paid upfront. This means there is no difference between cash basis and accrual basis taxpayers in relation to VAT claimed on acquisitions of goods under a hire purchase agreement.

New Zealand position

In New Zealand, the GST regime is governed by the *Goods and Services Tax Act 1985* ("NZ GST Act") and the collection and control of New Zealand GST is the responsibility of the Inland Revenue Department.

The ordinary time of supply rules in New Zealand operate such that a supply of goods and services is deemed to take place at the earlier of an invoice being issued by the supplier or the time any payment is received by the supplier in respect of the supply.[5]

While taxpayers utilising the cash accounting scheme (referred to in New Zealand as the payments basis) are generally only able to claim the GST paid to the extent of the payments actually made, New Zealand has specific 'time of supply rules' within the NZ GST Act which deem goods supplied under a hire purchase agreement to be supplied at the time that the agreement is entered into.

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[5] Section 9(1), Goods and Services Tax Act 1985

Sub-section 9(3) of the NZ GST Act provides that notwithstanding the ordinary rules relating to the time of supply of goods found under section 9(1) and 9(2), goods and services supplied under an agreement to hire are deemed to be supplied at the time that the agreement is entered into. Specifically the NZ GST Act states at subsection 9(3)(b):

> "Where goods and services are supplied under a hire purchase agreement (as defined in the Hire Purchase Act 1971), that supply shall be deemed to take place at the time the agreement is entered into."

Once the time of supply is established, section 20(3) of the NZ GST Act sets out when deductions can be made from output tax. Specifically subsection 20(3)(b) applies to registered persons who account for GST payable on a payments basis and states that the deduction from output tax should be:

> "...the amount of input tax - ...(iii) In relation to the supply of goods and services made during that taxable period to that registered person, not being a supply of goods and services to which subparagraph (i) of this paragraph applies..."

Subparagraph 20(3)(b)(i) relates essentially to progressive or periodic supplies and does not include goods supplied under hire purchase arrangements.

Therefore, output tax (GST payable) on the supply is calculated at the time the hire purchase agreement is entered into and the input tax paid by the recipient of the supply can be deducted from the recipient's relevant output tax for the period, at the time the agreement is entered into, irrespective of whether the hirer is on an accruals or a cash (payments) basis. Consequently, in New Zealand, due to the deemed time of supply rule, hirers who account for GST on a cash basis are able to claim the whole amount of the credit on the GST paid, upfront.

South African position

South African VAT is imposed under the *Value Added Tax Act 1991 (*"SA VAT Act"*).* Whilst being very similar to the New Zealand legislation, there are a number of subtle differences. For example, the terminology "hire purchase agreement" is not used in the South African VAT legislation; instead the term "instalment credit agreement" is used. An "instalment credit agreement" is, in part, defined to be:

> "...any agreement entered into on or after the commencement date whereby any goods consisting of corporeal movable goods or of any machinery or plant, whether movable or immovable-
>
> (a) are supplied under a sale under which-

(i) the goods are sold by the seller to the purchaser against payment by the purchaser to the seller of a stated or determinable sum of money at a stated or determinable future date or in whole or in part in instalments over a period in the future; and

(ii) such sum of money includes finance charges stipulated in the agreement of sale; and

(iii) the aggregate of the amounts payable by the purchaser to the seller under such agreement exceeds the cash value of the supply; and

(aa) the purchaser does not become the owner of those goods merely by virtue of the delivery to or the use, possession or enjoyment by him thereof; or

(bb) the seller is entitled to the return of those goods if the purchaser fails to comply with any term of that agreement; or…"

As with the New Zealand system, taxpayers utilising the cash accounting scheme (also referred to in South Africa as the payments basis) are generally only able to claim the VAT paid to the extent of the payments actually made, South Africa has specific 'time of supply rules', which deem goods supplied under a instalment credit agreement to be supplied at the time that the goods are delivered or any consideration is received[6]:

> "…where goods are supplied under an instalment credit agreement, that supply shall, subject to the provisions of subsection (2)(b), be deemed to take place at the time the goods are delivered or the time any payment of consideration is received by the supplier in respect of that supply, whichever time is earlier."

Once the time of supply is established, section 16(3) of the SAVAT Act sets out when deductions can be made from output tax. Specifically subsection 16(3)(b)(iii) applies to registered persons who account for VAT payable on a payments basis and states that the deduction from output tax should be:

> "…in the case of a vendor who is …required to account for tax payable on a payments basis, the amounts of input tax…in respect of supplies of goods and services made to the vendor during the tax period, excluding supplies of goods and services to which subparagraph (i) of this paragraph applies…"

[6] 9(3)(c) Value Added Tax Act 1991

Therefore, output tax (VAT payable) on the supply is calculated at the time the goods are delivered or any of the consideration received and the input tax paid by the recipient of the supply can be deducted from the recipient's relevant output tax for the period, at the time the goods are delivered or any of the consideration received, irrespective of whether the hirer is on an accruals or a cash (payments) basis. Consequently, in South Africa, as in New Zealand, hirers who account for VAT on a cash basis are able to claim the whole amount of the credit on the VAT paid, upfront.

Conclusion

In Australia, the Commissioner has stated at paragraph 214 of GSTR 2000/29 that he considers the basic attribution rules are appropriate. The Ruling argues that the basic attribution rules achieve the same result as if the hire purchase agreement were the sale of goods. It does not, however, recognise that the GST law also treats a "disclosed credit charge" hire purchase agreement as a financial supply. Therefore, in our opinion it would be "inappropriate" **not** to equate such a hire purchase agreement with a sale of goods that is financed by a loan.

The basic attribution rules are inappropriate in the case of a "disclosed credit charge" hire purchase agreement because they do not recognise a full input tax credit entitlement of the hirer at the time the goods are "sold" and the finance arrangement entered into.

The lack of neutrality in this respect (between a sale financed by chattel mortgage, a lease and a "disclosed credit charge" hire purchase agreement) makes the application of the basic attribution rules inappropriate such that the Commissioner is bound to make a determination to prevent the inconsistency occurring.

The UK, New Zealand and South African position in relation to the timing of input tax credit entitlement of hirers who account on a cash basis, demonstrates that the position taken by the ATO is inconsistent with the position taken by its international counterparts and inappropriate.

If you wish to discuss this matter further, please contact Deborah Jenkins on (02) 9335 7323 or me on (02) 9455 9315.

* * * * *

This advice is based upon *A New Tax System (Goods and Services Tax) Act 1999* together with subsequent amendments up to the date of this letter. Our advice is made in the absence of judicial guidance as to how the law will be interpreted in Australia to properly resolve many of the difficult questions of construction that arise. Our comments should be read with this in mind.

These comments are made specifically in response to your request for advice on behalf of Australian Equipment Lessors Association. Accordingly, neither the firm nor any member or employee of the firm undertakes responsibility in any way whatsoever to any person or company other than Australian Equipment Lessors Association for any errors or omissions in the advice given, however caused.

Yours sincerely

Michael Evans
Partner