

## **What is the best form of finance for a cash basis taxpayer under the GST?**

This is a difficult question to answer categorically because the GST implications of various finance products will change according to clauses within the agreement. In addition, taxpayers will need to undertake a detailed review of the following factors when selecting a form of a finance:

1. What are the prevailing finance costs associated with each form of finance?
2. What penalties/charges apply where the agreement is terminated prematurely?
3. What are the GST implications of the various forms of finance?

It is therefore vital that tax practitioners understand the needs of their clients before assisting in the selection of a finance product used to purchase a capital asset. We would always recommend that tax practitioners engage the services of finance experts when a client has requested assistance in selecting the most appropriate form of finance.

In considering the best form of finance for cash basis GST taxpayers, we have reviewed the following finance products:

1. an operating and finance lease;
2. a hire purchase agreement; and
3. a chattel mortgage.

### **Operating leases**

The GST implications of a lease are set out in point form below.

1. Operating and finance leases are not financial supplies and therefore are subject to GST.
2. A lease is a supply that is made on a progressive or periodic basis for the period of the lease and so Division 156 applies - refer S.156-22 GST Act.
3. Division 156 does not apply to the lessee if the lessee accounts for GST on a cash basis. Therefore, a cash basis taxpayer is entitled to input tax credits in respect of lease payments each time a payment is made under the agreement.

A cash basis taxpayer will also be entitled to claim input tax credits of 1/11<sup>th</sup> of prepaid lease payments.

4. If a lessee acquires an asset subject to a lease at the end of the agreement, then that is a separate supply and that will also be subject to GST. Reference should be made to GSTD 2000/D6.

## Hire Purchase Agreements

Unfortunately the Commissioner has decided not to take the opportunity to clarify the confusion regarding GST and hire purchase agreements in his latest GST ruling on the issue. Despite receiving many submissions from tax experts, including the NTAA, that his views about hire purchase agreements in GST Ruling GSTR 1999/D7 were not in accordance with the law, he has persisted with the same views in the final ruling - GSTR 2000/29.

Whilst from a practical point of view most people will follow what the Commissioner says, the problem will be that one day the matter may reach the courts and the court may disagree with the Commissioner's views. The fault lies in the legislation itself. The Commissioner is merely interpreting the legislation in a way in which Parliament intended it to operate but unfortunately the legislation itself is faulty.

Many of the technical issues aside, the GST and tax implications for taxpayers entering into a hire purchase agreement are as follows:

1. For income tax purposes, the hirer is treated as the owner from the time they enter into the hire purchase agreement and therefore may claim depreciation on the item - refer generally IT 196, TR 93/16, proposed new Division 240 ITAA 1997 and minutes of the National Tax Liaison Group meeting of 23 November 1994.
2. A hirer that accounts for GST on a cash basis is only entitled to an input tax credit equal to 1/11th of the capital portion of each hire purchase payment in the GST period in which the payment is made. As the Commissioner states in paragraph 212 of GSTR 2000/29:

*"If you account for GST on a cash basis and you make a creditable acquisition of goods under a hire purchase agreement, you attribute input tax credits for the acquisition to the tax periods in which you provide consideration for the acquisition but only to the extent that you provide consideration in those tax periods."*

Each time a hirer makes payment under the hire purchase agreement the hirer will need to determine how much of that payment is capital and how much is interest. The hirer will then be entitled to an input tax credit equal to 1/11th of the total of the capital payments made in that tax period.

3. There is no rule in the GST legislation how this break up should be calculated. Discussions with one of the authors of GSTR 2000/29 reveal that the following is likely to be acceptable:
  - the hirer should first ask the financier for a break down between capital and interest of each payment.
  - if no information is available from the financier the hirer should be able to calculate the break down themselves using either the actuarial method or the straight line method. The rule of 78 method is unlikely to be acceptable.
  - as long as a genuine attempt has been made to calculate the break down on a reasonable basis the ATO is unlikely to question it.

Given that the method for calculating the interest deduction under proposed Division 240 is based on the actuarial method, the NTAA recommends that the actuarial method be used.

4. If a taxpayer makes a prepayment or balloon payment at the commencement of the agreement, then the taxpayer will be entitled to an input tax credit of 1/11<sup>th</sup> of that part of the payment which represents capital.
5. When a cash taxpayer pays out the balloon or final payment under a hire purchase agreement then they will be entitled to claim 1/11th on that part of the payment which represents capital.

### ***GST Trap***

1. An input tax credit cannot be claimed unless the hirer is holding a tax invoice. The hire purchase agreement itself may constitute a tax invoice.
2. If the credit charges are not separately identified and disclosed to the hirer, all the consideration received or provided under the hire purchase agreement is consideration for the supply or acquisition of the goods. In this case the hirer will be entitled to an input tax credit equal to 1/11th of each payment.

## **Chattel mortgages**

Before outlining the GST and income tax implications of a chattel mortgage it is necessary to explain the nature of this rather unique finance facility.

A chattel mortgage occurs where a financier provides a loan or finance facility to a taxpayer and the taxpayer uses that facility to purchase a particular asset. Unlike hire purchase agreements, under a chattel mortgage a taxpayer becomes the owner of the asset at the time that the agreement is entered into. Security for this form of finance is a mortgage over the asset acquired.

The GST and income tax implications are as follows:

1. A cash basis taxpayer for GST purposes is entitled to claim all of their input tax credits in relation to an acquisition using this finance product at the commencement of the arrangement.

If a taxpayer who accounts for GST on a cash basis acquired a \$55,000 piece of machinery using this facility on 23 March 2001, then they would be entitled to input tax credits of \$5,000 (i.e. in 1/11<sup>th</sup> of \$55,000) at the commencement of the agreement (i.e. in the BAS for the quarter ended March 2001).

2. Cash basis taxpayers still retain their rights to depreciation in relation to assets acquired under this facility.
3. A taxpayer will not be entitled to input tax credits for the capital component of payments made under the agreement. Nor will a taxpayer be entitled to input tax credits for the finance charges that exist under this type of agreement.
4. Often, the interest charges under this type of facility are higher than a lease because the security under the facility will normally represent a depreciating asset. The reason being, finance companies are taking on greater risk with this type of product.

## **Summary**

Subject to variations that may occur in finance costs under each of these finance facilities, cash basis taxpayers will generally find a chattel mortgage to offer the best cash flow result from a GST perspective.

In addition, cash basis taxpayers using chattel mortgages as a finance facility will also be entitled to claim deductions for depreciation and interest, in much the same way as taxpayers who acquire assets using hire purchase agreements. Although, it must be remembered that taxpayers using a lease agreement will generally be entitled to claim an income tax deduction for the GST exclusive cost of the lease payments.

The table listed below examines each type of finance facility and the GST and income tax implications that also apply:

<b>Operating lease</b>	<b>Hire purchase</b>	<b>Chattel mortgages</b>
A taxpayer is entitled to claim an outright deduction for the GST exclusive value of the payments under the agreement*	A taxpayer will be entitled to claim a deduction for depreciation and interest.**	A taxpayer will be entitled to claim a deduction for depreciation and interest.**
A taxpayer will claim input tax credits each time that a payment is made under the lease agreement.	A taxpayer will be entitled to claim an input tax credit of 1/11th of the capital component of payments made under the HP agreement.	A taxpayer will be entitled to claim input tax credits of 1/11th of the purchase price of the asset.
A taxpayer will be required to pay GST on the residual or balloon payment made at the end of the agreement.	No extra GST will be payable by a taxpayer when they make the final payment to acquire the asset under the agreement.	No GST will be payable when a taxpayer makes the final payment under this agreement.

\* Taxpayers are also entitled to full input tax credits for payments that are made under a luxury car lease.

\*\* Where the asset acquired is a luxury car (i.e., valued at more than \$57,009) then the input tax credit entitlement will be limited to 1/11th of the motor vehicle depreciation limit (currently \$57,009).