

INTERPRETATION STATEMENT**GST and finance leases**

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IS 22/02

This interpretation statement explains how to classify finance leases for the purposes of the time of supply and value of supply rules. It also explains how to account for GST on finance leases when applying any special time and value of supply rules.

All legislative references are to the Goods and Services Tax Act 1985 unless otherwise stated.

REPLACES

- "GST and finance leases — classification, method of accounting and treatment of residual value clause", *Tax Information Bulletin* Vol 8, No 1 (July 1996): 1.

GST information rules

- For taxable periods beginning on or after 1 April 2023 a reference in this document to tax invoice is to be read as including a reference to taxable supply information. A reference to a credit note or a debit note is to be read as including a reference to supply correction information.

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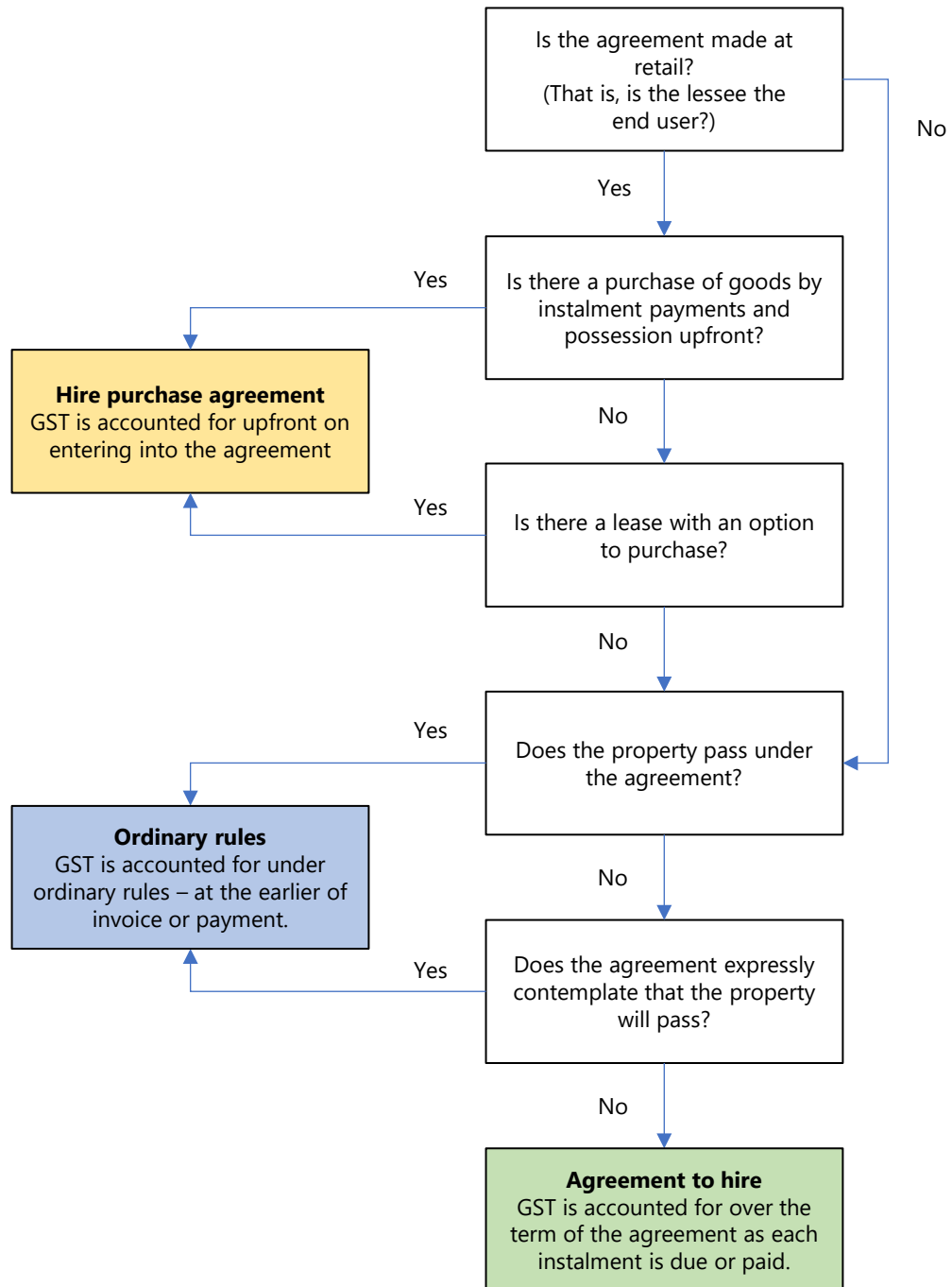
Summary

1. This interpretation statement explains how to classify finance leases for the purposes of the time of supply and value of supply rules. It also explains how to account for GST on finance leases when applying any “special” time and value of supply rules.
2. The term “finance lease” is not a defined term for GST purposes. It is a commercial term that describes a lease of an asset for a fixed term when the amounts payable by the lessee relate to the value of the leased goods and not the value of their use. The terms and conditions of a finance lease will vary from lease to lease. Accordingly, every finance lease arrangement needs to be considered on its own terms.

Classifying finance leases – time of supply

3. To apply the time of supply rules, it is necessary to correctly classify a finance lease as:
 - an **agreement to hire**, in which case the goods are treated as being successively supplied and each successive supply is treated as taking place at the earlier of when a payment becomes due or is received;
 - a **hire purchase agreement**, in which case the time of supply is the time the agreement is entered into; or
 - falling outside the previous two definitions (a **third category agreement**), so the ordinary rules will generally apply, and the time of supply is the earlier of the time the supplier issues an invoice or receives a payment for that supply.
4. In many cases a finance lease is an agreement to hire for GST purposes. However, a finance lease will not be an agreement to hire if the:
 - lessee is the end user of the goods and the lessor gives the lessee an option to purchase; or
 - property passes upfront or will definitely pass under the terms of the agreement.
5. The relevant time to classify a finance lease for GST purposes is the time at which the agreement is entered into. The same GST classification of a finance lease applies to both parties to the agreement.
6. The process for classifying finance leases for time of supply is summarised in Flowchart 1 – Classifying finance leases for time of supply.

Flowchart 1 – Classifying finance leases for time of supply



Classifying finance leases – value of supply

7. To apply the value of supply rules, it is necessary to determine whether a finance lease is a credit contract.
8. When a finance lease is a credit contract, GST is generally calculated on the “cash price” of the leased goods. The cash price is usually specified in the contract. The cash price is usually less than the total amount payable under the contract with the balance being interest or finance charges. Any interest or finance charges are financial services and exempt from GST (unless they are zero-rated under s 11A(1)(q)).
9. When a finance lease is not a credit contract, the ordinary rules apply. GST is calculated on the total amount payable under the lease (because there is no implied interest or finance component).
10. Whether a finance lease is a credit contract depends on whether it is a “credit contract” under the Credit Contracts Act 1981 (CCA).¹ However, the parties to a lease can elect to apply the definition in the Credit Contracts and Consumer Finance Act 2003 (CCCFA) to a particular arrangement if the CCCFA provides a different outcome. The lease contract and tax invoice(s) should reflect the agreed position.

Accounting for GST on finance leases

11. How to account for GST on a finance lease depends whether the lease is:
 - a hire purchase agreement, an agreement to hire or a third category agreement; and
 - a credit contract.
12. When a finance lease is a hire purchase agreement or third category agreement and a credit contract, GST is generally 3/23 of the cash price of the leased goods, payable upfront.
13. When a finance lease is a hire purchase agreement or third category agreement and not a credit contract, GST is 3/23 of the full consideration of the leased goods, payable upfront.
14. When a finance lease is an agreement to hire and a credit contract, GST is generally 3/23 of the cash price of the leased goods, spread over the payments to be made over the term of the lease. Lessors may adopt a straight-line basis to spread GST evenly over the term of the lease. Lessors must return output tax on the basis set out in the

¹ Although the CCA was repealed and replaced by the CCCFA, s 10(5A) defines credit contract by reference to s 3 of the CCA immediately before the repeal of that Act.

tax invoice. GST-registered lessees who acquire the goods for use in their taxable activity must, when claiming an input tax deduction, do so on the same basis adopted by the lessor, being as set out in the tax invoice.

15. When a finance lease is an agreement to hire and not a credit contract, GST is 3/23 of each lease payment made over the term of the lease.

Agency issues on selling goods

16. If a lessee sells the leased goods as agent for the lessor, the supply is deemed to be made by the lessor. The lessor must account for GST even if the lessee issues the tax invoice for the supply. The lessee is required to notify the lessor of the sale and provide sufficient information for the lessor to account for GST correctly. An exception to this treatment can apply where the lessee and lessor agree to treat the supply as two separate supplies.

Introduction

Reasons for updating the statement

17. This statement updates and replaces the Commissioner's view on how GST applies to finance leases as set out in "GST and finance leases — classification, method of accounting and treatment of residual value clause", *Tax Information Bulletin* Vol 8, No 1 (July 1996): 1 (the 1996 statement).
18. The key principles for applying GST to finance leases are unchanged from the 1996 statement. The main reasons for updating this statement are due to issues that have arisen since the 1996 statement including:
 - changes to the definition of "hire purchase agreement";
 - issues concerning the treatment of options to purchase;
 - whether business-to-business leases are made "at retail";
 - uncertainty about agreements that "expressly contemplate" property passing;
 - the new definition of "credit contract" under the CCCFA; and
 - agency issues on selling goods at the end of a lease.

What this statement covers

19. This interpretation statement is in four parts, covering:
- classifying finance leases – time of supply (from [22]);
 - classifying finance leases – value of supply (from [111]);
 - accounting for GST on finance leases (from [140]); and
 - agency issues on selling goods (from [169]).

What is meant by “finance lease”

20. This interpretation statement applies to finance leases.² The term “finance lease” is not a defined term for GST purposes. It is a commercial term that describes a lease of an asset for a fixed term when the amounts payable by the lessee (including a deposit or residual value payment) relate to the value of the leased goods and not the value of their use.
21. Under a finance lease, the total amount payable by the lessee ensures the lessor recovers the capital cost of the leased goods and makes a commercial return on that capital. Common examples of goods leased under finance leases are motor vehicles and office equipment, but finance leases can apply to a variety of different goods.

Classifying finance leases – time of supply

22. To apply the time of supply rules, it is necessary to correctly classify a finance lease as an agreement to hire, a hire purchase agreement or as falling outside these definitions, so a third category agreement. The classification determines whether GST is chargeable upfront or over the term of the lease.
23. The overall position at the end of the agreement is generally GST neutral, so the issue is one of timing. It is important the parties to a lease agreement are clear about the nature of the agreement so there is no timing mismatch for GST purposes. For GST purposes, an agreement has only one legal classification that determines its treatment under the GST Act for both parties to that agreement. Accordingly, both parties to a lease must adopt the same timing treatment.

² “Finance lease” is a defined term for income tax purposes. Broadly, under the Income Tax Act 2007 finance leases reflect the economic effect of the lease arrangement and deem the leased goods to have been sold by the lessor to the lessee. However, there is no equivalent express treatment of finance leases in terms of economic, rather than legal, effect in the GST Act.

24. The time of supply rules are set out in s 9. The general rule under s 9(1) is that time of supply is the earlier of the time:
- an invoice is issued by the supplier or the recipient; or
 - any payment is received by the supplier.
25. However, there are exceptions to the general rule for hire purchase agreements and agreements to hire. These exceptions are stated in s 9(3)(a)–(c):

9 Time of supply

...

(3) Notwithstanding anything in subsection (1) or subsection (2),—

(a) where goods are supplied under an agreement to hire, or where services are supplied under any agreement or enactment which provides for periodic payments, they shall be deemed to be successively supplied for successive parts of the period of the agreement or the enactment, and each of the successive supplies shall be deemed to take place when a payment becomes due or is received, whichever is the earlier:

...

(b) where goods and services are supplied under a hire purchase agreement, that supply shall be deemed to take place at the time the agreement is entered into:

(c) for the purposes of this subsection, the term **agreement to hire** means an agreement for the bailment of goods for hire and includes a lease of goods and a rental agreement; but does not include—

- (i) an agreement under which the property in the goods passes to the bailee or which expressly contemplates that the property in the goods will pass to the bailee; or
- (ii) a hire purchase agreement.

26. Section 9(3)(a) deems goods supplied under an agreement to hire to be successively supplied. It deems each successive supply to take place at the earlier of when a payment becomes due or is received. Accordingly, if a finance lease is an agreement to hire, GST is payable over the term of the lease each time a payment is due or received.
27. Section 9(3)(b) deems the time of supply to take place at the time the agreement is entered into for hire purchase agreements. Accordingly, if a finance lease is a hire purchase agreement, GST is accounted for upfront when the agreement is entered into.
28. The special timing rules in ss 9(3)(a) and (b) apply irrespective of whether a person accounts for GST on a payments basis or an invoice basis.

29. If a finance lease is a third category agreement, then (subject to the application of any other “special” time of supply rule) the ordinary rules apply. This means GST is usually accounted for upfront, at the earlier of the time the supplier issues an invoice or receives a payment for that supply.
30. It can be seen from this that correctly classifying a finance lease as an agreement to hire, a hire purchase agreement or a third category agreement has important consequences for the timing of a lessee’s and lessor’s GST liabilities. The important point when both parties are GST registered is that the parties classify the agreement in the same way for GST purposes. The terms of the agreement should be clear enough that both parties are able to reach the same conclusion on the nature of the agreement.
31. The rest of this section considers how to classify a finance lease for time of supply purposes. Because the definition of an agreement to hire in s 9(3)(c) specifically excludes a hire purchase agreement, the following analysis first considers when a finance lease will be a hire purchase agreement.

When finance leases are hire purchase agreements

32. A finance lease may, in some circumstances, be treated as a hire purchase agreement for GST purposes. “Hire purchase agreement” is defined in s 2(1):

hire purchase agreement has the same meaning as in section YA 1 of the Income Tax Act 2007; but includes an agreement that would be a hire purchase agreement but for the exclusion in paragraph (f) of the definition of that term in that section

33. The definition refers to the meaning of “hire purchase agreement” in s YA 1 of the Income Tax Act 2007:

hire purchase agreement—

- (a) means—
 - (i) an agreement under which goods are let or hired with an option to purchase, however the agreement describes the payments:
 - (ii) an agreement for the purchase of goods by instalment payments, however the agreement describes the payments, under which the person who agrees to purchase the goods is given possession of them before the total amount payable has been paid; and

- (b) includes an agreement to sell goods at retail under which—
 - (i) the buyer grants security over the goods to the seller for some or all of the purchase price; and
 - (ii) the property in the goods passes to the buyer subject to the security, in which case the agreement is a hire purchase agreement made at the time the sale is made; and
- (c) includes a sale and loan arrangement under which—
 - (i) a person lends money on the security of goods that have been bought or are to be bought at retail if some or all of the purchase price is paid out of the proceeds of the loan; and
 - (ii) the loan is made by the seller or by a third party, arranged by the seller, who is engaged in the business of lending money or who habitually lends money in the course of the third party's business, in which case the arrangement is a hire purchase agreement made at the time the loan is made; and
- (d) does not include an agreement of a kind described in paragraph (a)(i) or (ii) under which property in the goods passes absolutely, to the person who agrees to purchase the goods, at the time of the agreement or at the time of delivery of the goods or at any time before delivery of the goods; and
- (e) does not include an agreement made otherwise than at retail; and
- (f) does not include an agreement to the extent to which the property that is the subject of the agreement is livestock or bloodstock.

34. Relevantly, a hire purchase agreement, under the definition in s YA 1 of the Income Tax Act 2007, is an agreement:
- under which goods are let or hired with an option to purchase (para (a)(i)); or
 - for the purchase of goods by instalment payments; however, the agreement describes the payments under which the person who agrees to purchase the goods is given possession of them before the total amount payable has been paid (para (a)(ii)).
35. The definition does not include an agreement made otherwise than at retail (para (e)).
36. Other aspects of the definition are discussed from [74].

Agreements made at retail

37. The first point to consider is what “an agreement made otherwise than at retail” means. This is important because a finance lease can be a hire purchase agreement only if it is made “at retail”. If the agreement is not made at retail, then it will not be a hire purchase agreement. This means that to determine the time of supply for an agreement that is not made at retail, it is necessary to consider only whether the agreement is an agreement to hire or a third category agreement.
38. The Commissioner is aware of the view that the “at retail” requirement does not apply to business-to-business transactions and applies only in the context of private consumers or individuals. The Commissioner’s view is that business-to-business transactions can still be made at retail for the purposes of determining whether a lease is a hire purchase agreement. This view is based on the meaning of “at retail” set out below.
39. “At retail” and “retail” are not defined terms in the Act. The term “retail” is defined in the *Oxford English Dictionary* (Oxford University Press, online edition, last updated October 2021), as:³
- The action or business of selling goods in relatively small quantities for use or consumption rather than for resale.
40. The dictionary definition of “retail” indicates that an agreement is made “at retail” where the purchaser will use or consume the goods (rather than resell them). In comparison, “wholesale” is defined in the *Oxford English Dictionary* as:
- With reference to the selling of goods: in large quantities and at low prices, typically in order to be sold on by retailers at a profit.
41. New Zealand case law on the meaning of “at retail” also focuses on the use and consumption of the goods rather than whether the recipient is a business or private consumer. An agreement is made at retail if it is made otherwise than at wholesale (essentially sales to persons who buy to sell again) or privately.⁴
42. A GST-registered lessee entering into a leasing arrangement will do so at retail if the leased goods are for use in the registered person’s taxable activity, provided the registered person is not leasing the goods for the purpose of resale or long-term hire.⁵

³ <https://www.oed.com/>

⁴ *Provident Life Assurance Co Ltd v Official Assignee* [1963] NZLR 961 (CA) at 965.

⁵ *National Westminster Finance NZ Ltd v South Pacific Rent-a-Car Ltd* [1985] 1 NZLR 646 (HC) at 650; *National Westminster Finance NZ Ltd v South Pacific Rent-a-Car Ltd* [1985] 1 NZLR 655 (CA) at 656.

43. In the Australian case *Collector of Customs v Chemark Services Pty Ltd*, the full court of the Federal Court of Australia concluded that the words “retail sale” have generally acquired a specialised meaning of a sale to an ultimate consumer and that the use of the term does not limit such consumers to ordinary members of the public.⁶ The courts in both *National Westminster* and *Chemark* concluded that the size or quantity of the transaction is not determinative of whether a transaction is at retail.
44. The discernible purpose of the time of supply rule for hire purchase agreements is to account for GST upfront on agreements that are effectively sales where possession of the goods is given upfront. This is the case even though the goods are paid for over time and title does not generally pass until the goods have been paid for. This purpose does not support a distinction based on whether an agreement is between GST-registered parties.
45. Therefore, business-to-business transactions can still be made at retail for the purposes of determining whether a lease is a hire purchase agreement. The focus of “at retail” is whether the lessee is the ultimate consumer or end user of the goods. See Example 1 and Example 2.

Example 1 – Business-to-business agreement made at retail

Jack’s Carpet Cleaning Ltd needs a fridge–freezer with chilled water and an icemaker for the staffroom. Jack decides to lease a fridge from Big Retail Co. The term of the lease is 36 months, and Jack’s Carpet Cleaning Ltd will pay equal monthly instalments. Once the last payment has been made, ownership of the fridge will transfer to Jack’s Carpet Cleaning Ltd.

The agreement is made “at retail” because Jacks’ Carpet Cleaning Ltd is not on-selling or on-leasing the fridge long term; instead, it is using the fridge in its taxable activity.

Example 2 – Business-to-business agreement made otherwise than at retail

Finance Co Ltd leases a boat from Boat Manufacturer Ltd. Finance Co Ltd will on-lease the boat for its economic life to Choppy Charters Ltd.

The agreement between Finance Co Ltd and Boat Manufacturer Ltd is not made at retail because Finance Co Ltd is leasing the boat for the purpose of long-term hire to Choppy Charters Ltd. Finance Co Ltd is not the end user of the boat.

⁶ (1993) 114 ALR 531

Agreements with options to purchase

46. Agreements with options to purchase are a type of hire purchase agreement where a person hires the goods and has the option, but no obligation, to purchase the goods.⁷ The person has the use of the goods, but title does not pass until the option to purchase the goods is exercised.
47. While no legal obligation to buy the goods exists under this type of hire purchase agreement and no 'sale' occurs until the option is exercised, this type of agreement is treated as a 'sale' from a GST perspective and GST is accounted for upfront under s 9(3)(b).
48. An option to purchase is generally regarded as an offer to sell coupled with a contract not to revoke the offer.⁸ To be effective, the option must either set out the terms of the agreement that will be reached or provide machinery for the settlement of those terms. For example, the agreement must state the purchase price or provide a mechanism to determine the purchase price. An option can exist even if it is not described as an option in the agreement. It is the effect of the transaction that matters, not the description the parties give it.⁹
49. In the context of a finance lease, an option to purchase exists if:
- the lessee has the right to buy the goods; and
 - the lessor is obliged to sell the goods if the lessee exercises their right to buy.
50. One question that arises is whether the mere existence of an option to purchase is enough to make a hire agreement a "hire purchase agreement" for GST purposes. The Commissioner's view is that the language of the definition is clear and any option to purchase the goods is sufficient to bring a finance lease agreement within the definition of hire purchase agreement.
51. To summarise, where the lessee is the end user of the goods and the lessor gives the lessee an option to purchase the goods, the agreement is a hire purchase agreement for GST purposes and GST is accounted for at the time the agreement is entered into. See Example 3. A lease with an option to purchase where the lessee is not the end user of the goods, will be an agreement to hire, as discussed from [80].

⁷ *Helby v Matthews* [1895] AC 471 (HL).

⁸ *Alexander v Tse* [1988] 1 NZLR 318 (CA) at 324–325; *Murray v Scott* [1976] 1 NZLR 643 (SC) at 655–656; *Jane v Ben Hall Properties Ltd* [1979] 2 NZLR 68 (CA) at 73.

⁹ *Adaras Developments Ltd v Marcona Corp* [1975] 1 NZLR 324 (HC) at 332 ("option" held to be a right of pre-emption); *Woodroffe v Box* (1954) 92 CLR 245 (HCA) (right of "first refusal" held to be an option).

Example 3 – Lease with an option to purchase the goods

Building Co Ltd is GST registered and needs a crane for use in its construction business. It enters into a lease agreement with Finance Co Ltd. Under the agreement, Building Co Ltd will make monthly lease payments for 15 years. At the end of the lease, Building Co Ltd has the option to purchase the crane for \$1.

The agreement is a hire purchase agreement because Building Co Ltd has entered into an agreement under which it has leased goods (the crane) with an option to purchase the goods. The agreement is made at retail because Building Co Ltd is using the crane in its taxable activity.

Both Building Co Ltd and Finance Co Ltd must account for GST at the time the agreement is entered into under s 9(3)(b).

Change to the legislation

52. From 1 April 2005 to 22 November 2013 a drafting error in para (a)(i) of the definition of hire purchase agreement in s YA 1 of the Income Tax Act 2007 arguably meant a person's upfront agreement to purchase the goods was required in order for a lease with an option to purchase to be a hire purchase agreement.
53. This error was amended in 2014 and can no longer be relied on to exclude a lease with an option to purchase from being a hire purchase agreement. An exception applies for tax positions taken from 1 April 2005 to 22 November 2013 that rely on the definition as it was before the amendment.
54. Accordingly, parties to a lease with an option to purchase must consider whether the agreement is made at retail to determine whether the agreement is a hire purchase agreement.

Interrelated and side agreements

55. Sometimes the parties to a finance lease will enter into more than one agreement for the same goods at the outset of the lease. For example, the parties may enter into a lease agreement for goods and a separate option to purchase the goods. These agreements may be written or oral agreements. In these situations, it is necessary to determine the true legal nature of the arrangement.
56. Classifying a particular agreement requires a careful analysis of the documentation and, in some cases, the factual context (including such things as other written and oral arrangements between the parties that affect the terms of the documentation).

However, this does not involve substituting the legal arrangements for an assessment of the overall economic consequences of the transaction.¹⁰

57. The true nature of an agreement can be ascertained only by careful consideration of the legal arrangements entered into and carried out. Consideration must be given to the whole of the contractual arrangements, and, if the transaction is embodied in a series of interrelated instruments, all the agreements must be considered together and one may be read to explain the others.¹¹
58. The relevant time to determine whether an agreement (including any side agreements) is a hire purchase agreement for GST purposes is the time at which the agreement is entered into.
59. For example, if a hire agreement and an option to purchase are entered into by the same parties about the same time and for the same goods, then the documents are interrelated and should be read together as one agreement. In these circumstances, the agreement would be a hire purchase agreement (if it was made at retail). See Example 4.

Example 4 – Option granted at the outset of the lease

Bobbi the builder needs a vehicle for use in her business. She enters into a lease agreement for a vehicle with Finance Co Ltd. The lease agreement is for 5 years. On the same day, Bobbi also enters into a separate agreement in writing with Finance Co Ltd for an option to purchase the vehicle for a small fee on termination of the lease agreement.

Although the lease and the option are in two separate documents, these documents are interrelated and part of the same agreement. The option to purchase the vehicle for a small fee would not be available if it were not for the existence of the lease agreement for that vehicle.

The agreement is a hire purchase agreement. The lease agreement and the option to purchase were entered into by the same parties about the same time and for the same goods. Therefore, the agreement as a whole is one under which goods are leased with an option to purchase.

Both Bobbi the builder and Finance Co Ltd must account for GST at the time the agreement is entered into under s 9(3)(b).

¹⁰ *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 (CA) at 145 and 167; *Marac Life Assurance Ltd v CIR* (1986) 8 NZTC 5,086 (CA).

¹¹ *Marac Finance Ltd v Virtue* [1981] 1 NZLR 586 (CA).

Residual value clauses

60. In many cases, a finance lease will have a residual value clause. An issue that has arisen is whether a residual value clause can be an “option to purchase”. Residual value clauses come in different forms.
61. In its simplest form, a residual value clause simply requires the lessee to “guarantee” to the lessor that the leased goods will have a certain value at the end of the lease. The finance lease makes it clear that ownership of the goods always remains with the lessor, and the lessee is obliged to return the goods to the lessor at the end of the lease. Such residual value clauses then usually oblige the lessor to sell the leased goods with the lessee making up any shortfall in value up to the “guaranteed” amount. Some residual value clauses provide for the lessor to pay any amount gained on sale over the guaranteed value to the lessee. If the lessee fails to return the goods at the end of the term of a finance lease, some residual value clauses require the lessee to pay the residual value to the lessor.
62. On its own, a guaranteed residual value is not legally an option to purchase the goods. There is generally no offer to sell the goods, the lessee has no right to purchase the goods and there is no mechanism by which to transfer title.
63. Difficulties may arise where the lessee does not return the goods at the end of the lease and the lease agreement requires the lessee to pay the residual value to the lessor. The parties might then agree that ownership of the leased goods will pass to the lessee for a further nominal consideration. In legal terms, this sale is a separate contract from the finance lease. GST must be returned on the value of the consideration for the sale, if any.
64. If the agreement to transfer ownership is not made until a later date, whether that is before the end of the hire period, on termination of the agreement or after the agreement ends, the transfer of ownership will be a separate agreement from the finance lease.
65. However, if the residual value clause allows the lessee to retain possession of the goods by paying the residual value and allows for ownership to transfer to the lessee, then legally this is an option irrespective of the words the parties use to describe it. The lessee has the right to buy the goods and the lessor is obliged to sell the goods if the lessee exercises their right to buy. In this case, the agreement will be a hire purchase agreement.
66. The same GST classification of a finance lease applies to both parties to the agreement. The terms of the agreement should be clear enough that both parties can reach the same conclusion on the nature of the agreement.

Summary for options to purchase

67. In summary, one type of hire purchase agreement is an agreement under which goods are let or hired with an option to purchase. It does not matter whether the option is exercised. Leases with options where the lessee is the end user of the goods will be a hire purchase agreement and GST must be accounted for by both parties at the time the agreement is entered into. Whether or not a residual value clause or any side agreements indicate that an agreement contains an option to purchase will depend on the circumstances. See Example 5 to Example 9.

Example 5 – Agreement where lessee returns goods under residual value clause

Sparkle Ltd leases a car for use in its business from Finance Co Ltd. The agreement states that Sparkle Ltd does not have a right to buy the car under the agreement and that ownership of the car remains with Finance Co Ltd. The agreement has a guaranteed residual value of \$25,000 and requires Sparkle Ltd to return the car to Finance Co Ltd at the end of the lease. Finance Co Ltd is required to sell the car at the end of the lease. If the net sale price is less than the residual value, Sparkle Ltd must pay the difference to Finance Co Ltd.

At the end of the lease, Sparkle Ltd returns the car to Finance Co Ltd. Finance Co Ltd sells the vehicle for \$20,000 net of expenses. Sparkle Ltd is required to pay the difference of \$5,000 to Finance Co Ltd.

The agreement is not a hire purchase agreement. No option exists to purchase the goods under the agreement.

Example 6 – Agreement where lessee retains goods under residual value clause

This example is a variation on Example 5. The facts are the same as in Example 5 except the residual value clause provides that if Sparkle Ltd does not return the vehicle at the end of the lease, Sparkle Ltd must pay the residual value to Finance Co Ltd.

One month before the end of the lease, Sparkle Ltd tells Finance Co Ltd that it wants to retain the car at the end of the lease and will pay the residual value. Sparkle Ltd and Finance Co Ltd agree that Finance Co Ltd will transfer ownership to Sparkle Ltd once Finance Co Ltd has received the payment of the residual value (and all other money owed under the contract).

The agreement is not a hire purchase agreement. Sparkle Ltd had no right to purchase the car under the written agreement and no other written or oral agreements were

entered into at about the same time as the lease that would give Sparkle Ltd the right to buy the car.

Example 7 – Residual value clause legally an option

This example is a variation on Example 5. The facts are the same as in Example 5 except the residual value clause provides that if Sparkle Ltd does not return the vehicle at the end of the lease, Sparkle Ltd must pay the residual value to Finance Co Ltd. The agreement also provides that if Sparkle Ltd retains possession of the vehicle and pays the residual value, then property in the vehicle will pass to Sparkle Ltd.

The agreement refers to the clause as a residual value clause and does not use the term "option". However, legally, because Sparkle Ltd has a right to buy the goods and Finance Co Ltd has agreed that title will pass if Sparkle Ltd retains the goods and pays the residual value, this is an agreement with an option. Therefore, the agreement is a hire purchase agreement. Both parties must account for GST at the time the agreement is entered into.

Example 8 – Option to purchase the goods for the residual value

Matte Ltd leases goods for use in its business from Finance Co Ltd. The agreement states that Finance Co Ltd retains ownership of the goods for the term of the lease. The agreement states that Matte Ltd must return the goods to Finance Co Ltd at the end of the lease. However, Matte Ltd also has the option to purchase the goods for the residual value of \$1 if Matte Ltd notifies Finance Co Ltd within 7 days of making the final payment that it wishes to exercise the option.

Matte Ltd notifies Finance Co Ltd within the required timeframe that it wishes to exercise the option and makes payment of \$1.

The agreement is a hire purchase agreement. At the time the agreement is entered into, the terms of the agreement include both a lease and an option to purchase the goods. Both parties must account for GST at the time the agreement is entered into.

Example 9 – Offer to buy made at the end of the lease

Zany Ltd leases goods for use in its business from Finance Co Ltd. The agreement states that Finance Co Ltd retains ownership of the goods for the term of the lease. The agreement states that Zany Ltd must return the goods to Finance Co Ltd at the end of the lease. The agreement also states that when the lease comes to an end, Zany Ltd can make an offer to purchase the goods for any price. Finance Co Ltd has the right to accept or reject the offer.

The agreement is not a hire purchase agreement. Zany Ltd has no right to purchase the goods under the written agreement. Zany Ltd can make an offer that Finance Co Ltd may accept. However, legally, that is not an option because, while Zany Ltd has the right to offer to buy the goods, Finance Co Ltd is **not** obliged to sell the goods if Zany Ltd exercises its right to offer to buy.

Agreements to purchase goods by instalment payments

68. The other type of hire purchase agreement is an agreement for the purchase of goods by instalment payments where the purchaser is given possession before the total amount payable has been paid. It does not matter how the instalment payments are described in the agreement (for example, as rent, lease or hire payments).
69. This type of agreement is legally an agreement to buy the goods.¹² The purchaser takes possession of the goods upfront and the purchase price is paid by instalments – often with a deposit upfront and sometimes with a larger “balloon payment” at the end. The purchaser becomes the owner of the goods once all instalment payments have been made.
70. The contract may describe the instalment payments as hire, lease or rental payments. However, despite the label given to the instalment payments, the purchaser is contractually committed to buying the goods. This type of agreement is often referred to as a “conditional sale agreement” because title does not pass until all the money owing under the agreement is paid and any other obligations under the agreement are fulfilled. This is different to a hire agreement with an option to buy the goods, where there is merely an option to buy and no obligation.
71. A financing arrangement for the lease, hire or purchase of goods will be a hire purchase agreement under para (a)(ii) of the definition in s YA 1 of the Income Tax Act 2007 if the relevant requirements are met. The label given to the arrangement (for

¹² *Lee v Butler* [1893] 2 QB 318 (CA).

example, finance lease or hire purchase agreement) or the label given to the payments does not determine the GST treatment.

72. Examples of finance leases that are conditional sale agreements occur in *National Westminster and Aubit Industries Ltd v Cable Price Corp Ltd*.¹³
73. Accordingly, where an agreement to purchase goods by instalment payments has the “lessee” being given possession of the goods before the total payment is made, this will be a hire purchase agreement if the lessee is the end user. Both parties to the transaction will need to account for GST on the agreement upfront. See Example 10. If the lessee is not the end user of the goods, the agreement will be a third category agreement as discussed from [104].

Example 10 – Lease to buy agreement

Alpha Ltd enters into a lease to buy office furniture from Finance Co Ltd. The agreement provides for regular monthly lease payments for 24 months. Finance Co Ltd delivers the furniture to Alpha Ltd once the agreement has been entered into and Alpha Ltd has made the initial payment. Once the final payment is made (and all other money owing under the agreement has been paid), Finance Co Ltd will transfer ownership of the office equipment to Alpha Ltd.

The agreement is a hire purchase agreement. Alpha Ltd has possession of the furniture upfront and has agreed to make all the lease payments. When Alpha Ltd has made all the payments under the lease, it will become the owner of the furniture. Alpha Ltd has agreed to buy the goods.

Both Alpha Ltd and Finance Co Ltd are required to account for all the GST on the supply at the time the agreement is entered into.

Other aspects of the definition of a “hire purchase agreement”

74. Under s YA 1 of the Income Tax Act 2007, a hire purchase agreement also includes:
- an agreement to sell goods at retail where the buyer grants security over the goods to the seller for some or all of the purchase price and the property in the goods passes to the buyer subject to the security (para (b)); and
 - a sale and loan arrangement under which a person lends money on the security of goods bought at retail if various conditions are met (para (c)).

¹³ *Aubit Industries Ltd (in rec and in liq) v Cable Price Corp Ltd* (1994) 5 NZBLC 103,395 (CA).

75. Absent the provisions listed above, transactions involving a sale combined with either a loan or security would be taxed as sales for GST purposes in any event. Output tax would be payable upfront as for any other sale. Accordingly, these provisions do not appear to be strictly necessary for timing purposes. It is likely that, because the definition of hire purchase agreement was taken from the Hire Purchase Act 1971 (repealed), these provisions have simply been carried through to the definition for GST purposes. The effect of these provisions means these agreements are treated as hire purchase agreements rather than sales, although with the same GST timing outcome.
76. The definition of hire purchase agreement makes it clear that a hire purchase agreement does not include an agreement where property passes absolutely to the purchaser at the time of the agreement or on or before delivery of the goods (unless the agreement is of a kind described in [74]).
77. It is a feature of hire purchase agreements that the lessee/purchaser gets the use of the goods without having to pay the full purchase price when the goods are handed over. Ownership generally remains with the lessor/vendor until any option to purchase is exercised or until the total amount payable has been paid under a purchase by instalment payments.
78. Paragraph (f) of the definition in the Income Tax Act 2007 excludes livestock and bloodstock from the definition of hire purchase agreement for income tax purposes. However, the s 2 definition in the GST Act specifically brings livestock and bloodstock back into the definition of hire purchase agreement for GST purposes.

Summary for hire purchase agreements

79. The situation for hire purchase agreements can be summarised as follows:
- The relevant time to determine whether a finance lease is a hire purchase agreement for GST purposes is the time at which the agreement is entered into. If a finance lease is a hire purchase agreement, GST is accounted for upfront – at the time the agreement is entered into.
 - The same GST classification of a finance lease applies to both parties to the agreement. The terms of the agreement should be clear enough that both parties can reach the same conclusion on the nature of the agreement because there is only one correct classification.
 - Whether a finance lease is made at retail depends on whether the lessee is the end user of the goods. A business-to-business lease can be made at retail.
 - A lease with an option to purchase where the lessee is the end user of the goods is a hire purchase agreement. The mere existence of an option to purchase is

enough to make a hire agreement a hire purchase agreement for GST purposes (if the lessee is the end user). A lease with an option to purchase where the lessee is not the end user of the goods, will be an agreement to hire, as discussed from [80].

- If a hire agreement and a separate option to purchase are entered into by the same parties about the same time and in relation to the same goods, then the documents are interrelated and should be read together as one agreement.
- A lease that is an agreement for the purchase of goods by instalment payments by the lessee as end user of the goods is a hire purchase agreement. If the lessee is not the end user of the goods, the agreement will be a third category agreement as discussed from [104]. This outcome arises because property in the goods passes under the agreement (or the agreement expressly contemplates that property in the goods will pass).
- A residual value clause in a finance lease requiring the lessee to pay the guaranteed residual value amount if they do not return the goods is not legally, on its own, an option to purchase the goods. However, if there is also an agreement that ownership will pass to the lessee for nominal consideration, then this may be an option to purchase the goods.

When finance leases are agreements to hire

80. If a finance lease is not a hire purchase agreement, it might be an agreement to hire. An “agreement to hire” is defined in s 9(3)(c):

9 Time of supply

...

(3) Notwithstanding anything in subsection (1) or subsection (2),—

...

(c) for the purposes of this subsection, the term **agreement to hire** means an agreement for the bailment of goods for hire and includes a lease of goods and a rental agreement; but does not include—

- (i) an agreement under which the property in the goods passes to the bailee or which expressly contemplates that the property in the goods will pass to the bailee; or
- (ii) a hire purchase agreement.

81. The consequence of a finance lease being treated as an agreement to hire is that GST is not accounted for upfront but is spread over time under s 9(3)(a).

82. An agreement to hire includes a lease of goods but it does not include an agreement:
- under which the property in the goods passes to the lessee; or
 - that expressly contemplates that the property in the goods will pass to the lessee.
83. Therefore, if, under the terms of the finance lease, property either passes to the lessee or is expressly contemplated to pass to the lessee, those agreements will not be agreements to hire. This makes sense as these agreements are not true agreements to hire.

Agreements where property passes

84. An agreement to hire does not include an agreement under which property in the goods passes to the lessee. This exclusion applies to agreements where it is certain under the terms of the agreement that title will pass, regardless of whether the title passes upfront or at the end of the agreement. This type of agreement is in effect an agreement to buy the goods and not just a simple rental agreement.
85. An example of this type of agreement is an agreement to purchase goods by instalment payments. Practically, the exclusion applies to this type of agreement only if the lessee is not the end user of the goods. If the lessee is the end user of the goods, this agreement will be a hire purchase agreement and excluded from being an agreement to hire under s 9(3)(c)(ii).
86. This exclusion does not apply to an agreement where an option to purchase exists. The existence of an option does not provide any certainty that title will pass. No obligation exists to buy the goods, just an option that may or may not be exercised.
87. This exclusion also does not apply where an option to purchase is exercised and property passes at the end of the lease under the terms of the agreement. While it could be argued that this situation involves an agreement under which property passes, it is possible to know this outcome only in hindsight. In the context of the time of supply rules, the amount of GST to be accounted for must be known with certainty at the time of supply. This means that certainty about when to account for GST is required at the earlier of invoice or payment.
88. Therefore, the Commissioner's view is that an agreement under which it is possible that title will pass but where it cannot be said for certain at the time of supply that title will pass does not fall within this exclusion.

89. For completeness, this exclusion does not cover situations where title passes at the end of the agreement but the transfer of ownership was not part of the original terms of the agreement at the time it was entered into. Once again, this could not be certain at the time of supply and the subsequent agreement to buy the goods would be a separate agreement.

Agreements that expressly contemplate property will pass

90. An agreement to hire also excludes any agreement that expressly contemplates that the property in the goods will pass to the lessee. It is necessary to consider the meaning of the phrase “expressly contemplates” in order to understand the difference between the first and second limbs of s 9(3)(c)(i).
91. The Commissioner accepts that the words “an agreement which expressly contemplates that the property in the goods will pass to the bailee” can be read narrowly or more broadly:
- The words can be read narrowly to mean an agreement that clearly intends that ownership of the goods will pass to the lessee. This could include agreements where property will pass provided instalment payments are made.
 - The words can also be read more widely to include an agreement that envisages or considers the possibility that property will pass. This could include a contingency that the parties explicitly allowed for in the terms of the agreement. On this interpretation, an agreement with an option to purchase the goods would be included in the second limb.
92. The Commissioner notes that the words of the second limb come from United Kingdom value-added tax (VAT) legislation where it seems to have been accepted as applying to hire purchase agreements with an option to purchase the goods.¹⁴
93. However, the Commissioner’s view is that this exclusion applies to agreements only where it is certain under the terms of the agreement that title will pass, regardless of whether title passes upfront or at the end of the agreement. An example of this type of agreement is an agreement where property will pass provided instalment payments are made. This exclusion is not intended to include an agreement with an option to purchase, even where that option is exercised. An agreement with an option to purchase the goods is an agreement to hire unless the lessee is the end user of the goods, in which case it is a hire purchase agreement.

¹⁴ *Rodney Crawford Hogarth t/a Hogarth Associates v Customs and Excise Commissioners* (1994) VT 13259; *General Motors Acceptance Corp (UK) plc v Customs and Excise Commissioners* (2003) VT 17990 upheld by the High Court in *Customs & Excise Commissioners v General Motors Acceptance Corp (UK) plc* [2004] EWHC 192 (Ch). Both cases seem to accept the proposition without detailed analysis.

94. This is consistent with the Commissioner's view in the 1996 statement. It is supported by a report to the Finance and Expenditure Committee in July 1986 when the second limb was added to s 9(3)(c)(i).¹⁵ The background to the amendment was that, arguably, it was not clear whether the original limb encompassed situations where the property in the goods passed at a point after the agreement was entered into, so the second limb was added to complement and clarify the original limb. The report states:

Comment

The scheme of the Act contemplates that where property in goods passes to a purchaser, the time of supply will be at the earlier of payment or invoicing. This is achieved specifically in relation to hire purchase sales by section 9(3)(b) ... whereby the time of supply is deemed to be when the agreement is entered into. The purpose of section 9(3)(c)(i) is to ensure similar treatment for other types of conditional sales where property will eventually definitely pass consequent upon the performance of certain conditions by the purchaser.

Where there is merely an option to purchase at some determinate or indeterminate date in the future it is the Department's view that a series of successive services are performed which are taxable at the time successive payments become due or are received. If the option to purchase is exercised there will be a separate supply of goods at the time the option is exercised and tax will be chargeable on whatever consideration is agreed for that supply without regard to tax charged on previous rental payments. As this payment will no doubt be adjusted by the supplier having regards to previous rental payments there will be no need for further adjustments as required in the case of goods sold under hire purchase agreements where there is a subsequent repossession.

If, as submitted, the definition in section 9(3)(c)(i) fails to achieve this result, it may be possible to follow the UK approach by rewording the subparagraph as follows: "An agreement under which property passes or which expressly contemplates that property in the goods will pass at some time in the future;".

Recommendation

It is recommended that the definition of "agreement to hire" in section 9(3)(c)(i) ... is amended to ensure that it excludes those agreements under which property passes or will (expressly) pass.

95. The report to the Finance and Expenditure Committee makes it clear that s 9(3)(c)(i) as a whole is intended to apply to agreements under which property will definitely pass. It states that an agreement with an option to purchase will be an agreement to hire.

¹⁵ *Taxation Reform Bill 1986* (Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill, July 1986).

96. Therefore, in the context of finance lease arrangements in New Zealand and given the clear legislative purpose in the report to the Finance and Expenditure Committee, the Commissioner's view remains that expressed in [93]. This exclusion applies to agreements only where it is certain under the terms of the agreement that title will pass, regardless of whether title passes upfront or at the end of the agreement.

Relevance of HMRC v Mercedes-Benz Financial Services UK Ltd

97. It has been suggested that the 2017 decision of the Court of Justice of the European Union (CJEU) in *Case C-164/16 – HMRC v Mercedes-Benz Financial Services UK Ltd* ECLI:EU:C:2017:734 could be relevant to how s 9(3)(c)(i) should be applied in New Zealand. The issue in that case was whether an agreement to lease a motor vehicle with an option to purchase that vehicle "expressly contemplate[s] that the property will pass at some time in the future" (cl 1(2)(b) of sch 4 of the Value Added Tax Act 1994 (UK)).
98. The words from the UK VAT legislation are similar to the words of s 9(3)(c)(i). However, the words from the UK VAT legislation need to be read in light of the words of the European Union VAT Directive.¹⁶ The question in *Mercedes* was whether the agreement was a contract for hire that provides that "in the normal course of events" ownership is to pass and this is based on the wording of the VAT Directive (art 14(2)(b)).
99. The CJEU ruled (at [43]):
- the words "contract for hire which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment" ... must be interpreted as applying to a leasing contract with an option to purchase if it can be inferred from the financial terms of the contract that exercising the option appears to be the only economically rational choice that the lessee will be able to make at the appropriate time if the contract is performed for its full term ...
100. Essentially, the CJEU distinguished between options where the lessee has a genuine decision to make in determining whether to exercise the option and options where the only economically rational choice is to exercise the option (for example, an option for \$1). The CJEU concluded that contracts with options where the only economically rational choice was that the lessee would exercise the option were agreements where property would pass in the normal course of events. The argument seems to be that in a New Zealand context, contracts with, say, an option to purchase for \$1 should be treated as agreements that expressly contemplate that the property in the goods will pass to the lessee.

¹⁶ Council Directive 2006/112/EC of 28 November 2006 on the Common System of Value Added Tax (VAT Directive).

101. While the Commissioner appreciates that argument, she considers the approach in *Mercedes* should not be applied in New Zealand. Although nothing turned on the difference between **in the normal course of events** (VAT Directive) and **which expressly contemplate** (UK VAT legislation), it is the words “in the normal course of events ownership is to pass” that the CJEU interpreted. Additionally, if the Commissioner were to follow the case, this would introduce further uncertainty through needing to determine which agreements with options should be regarded as expressly contemplating the property will pass.
102. The current approach means agreements with options made at retail are treated as “sales” rather than “leases” under the definition of hire purchase agreement, while agreements with options not at retail are treated as “leases”. Adopting the *Mercedes* approach would not entirely address this inconsistency because it applies only to options not at retail. See Example 11 to Example 12.

Example 11 – Finance lease that is an agreement to hire (residual value clause)

Koa’s Farms Ltd leases a tractor for use in its taxable activity from Finance Co Ltd. The lease term is 5 years, and Koa’s Farms Ltd makes monthly rental payments. The lease agreement has a guaranteed residual value and states that ownership remains with Finance Co Ltd. At the end of the lease, Koa’s Farms Ltd is required to return the tractor to Finance Co Ltd. If Koa’s Farms Ltd does not return the tractor, Koa’s Farms Ltd is required to pay the guaranteed residual value to Finance Co Ltd.

At the end of the lease, Koa’s Farms Ltd decides not to return the tractor and pays the guaranteed residual value to Finance Co Ltd. At that time, Koa’s Farms Ltd and Finance Co Ltd agree that ownership of the tractor will pass to Koa’s Farms Ltd.

The lease is an agreement to hire. Although the agreement is made at retail, no obligation or option exists for Koa’s Farms Ltd to buy the tractor and the agreement does not expressly contemplate that the tractor will pass to Koa’s Farms Ltd. Both parties account for GST on the monthly rental payments over the term of the agreement.

Example 12 – Finance lease that is an agreement to hire (option not at retail)

Finance Co Ltd leases a boat from Boat Manufacturer Ltd. Finance Co Ltd will on-lease the boat for its economic life to Voyage Ltd. Finance Co Ltd has the option to purchase the boat for \$1 at the end of the lease term.

The lease is an agreement to hire because it is not made at retail (Finance Co Ltd is not the end user of the boat as it has leased the equipment for the purpose of long-term hire to Voyage Ltd) and the agreement does not expressly contemplate that property in the goods will pass.

Both Finance Co Ltd and Boat Manufacturer Ltd account for GST over the term of the agreement.

Example 13 – Finance lease that is not an agreement to hire or a hire purchase agreement

TopTele Ltd leases 50 televisions from Finance Co Ltd. TopTele Ltd on-leases the televisions for their economic life to various customers. The agreement between TopTele Ltd and Finance Co Ltd provides for regular monthly lease payments for a period of 24 months. Once the final payment is made (and all other money owing under the agreement has been paid), Finance Co Ltd will transfer ownership of the televisions to TopTele Ltd.

The lease is not an agreement to hire or a hire purchase agreement. It is not an agreement to hire because at the time the agreement is entered into it is clear property in the goods will pass to TopTele Ltd at the end of the lease (if the contract proceeds as intended). The lease is also not a hire purchase agreement because it is not made at retail – TopTele Ltd is not an end user and has leased the equipment for the purpose of long-term hire to customers.

Both TopTele Ltd and Finance Co Ltd are required to account for all the GST on the supply at the earlier of the time the supplier issues an invoice or receives a payment for that supply, which is likely to be when they enter into the agreement.

Summary for agreements to hire

103. The situation for agreements to hire can be summarised as follows:

- Typically, a finance lease will be an agreement to hire where the lessor always retains ownership of the goods and the lessee returns the goods to the lessor at the end of the lease. Many finance leases provide an express statement that property in the leased goods remains with the lessor and that the lessee has no option to acquire property in the leased goods.
- Finance leases where property either passes to the lessee or is expressly contemplated to pass to the lessee are not agreements to hire.

- The Commissioner's view is that "an agreement which expressly contemplates that the property in the goods will pass" applies to agreements only where it is certain under the terms of the agreement that title will pass, regardless of whether title passes upfront or at the end of the agreement. It is not intended to include an agreement with an option to purchase even if it is highly likely the option will be exercised because that is the economically rational decision.
- Finance leases with options to purchase will be agreements to hire when the lessee is not the end user of the goods. If the lessee is the end user of the goods, the finance lease is a hire purchase agreement and s 9(3)(b) applies.
- If a finance lease is an agreement to hire, GST is accounted for over the term of the lease.

When finance leases are third category agreements

104. For convenience, we have described an agreement that falls outside the definitions of hire purchase agreement and agreement to hire as a third category agreement. Effectively, this category encompasses agreements where the property passes or which expressly contemplate that property will pass to the lessee, but which are not hire purchase agreements.
105. A finance lease is likely to be a third category agreement if:
- the lessee is not the end user of the goods; and
 - the agreement is one where the property will definitely pass under the terms of the agreement.
106. An example of this type of agreement is an agreement to purchase goods by instalment payments where the lessee is not the end user of the goods. The third category does not include finance leases with an option to purchase where the lessee is not the end user – this is an agreement to hire, as considered from [80].
107. If a finance lease is a third category agreement, then the general time of supply rule applies (subject to any other "special" time of supply rules). GST is accounted for at the earlier of the time the supplier issues an invoice or receives a payment for that supply (s 9(1)).

Summary – time of supply for finance leases

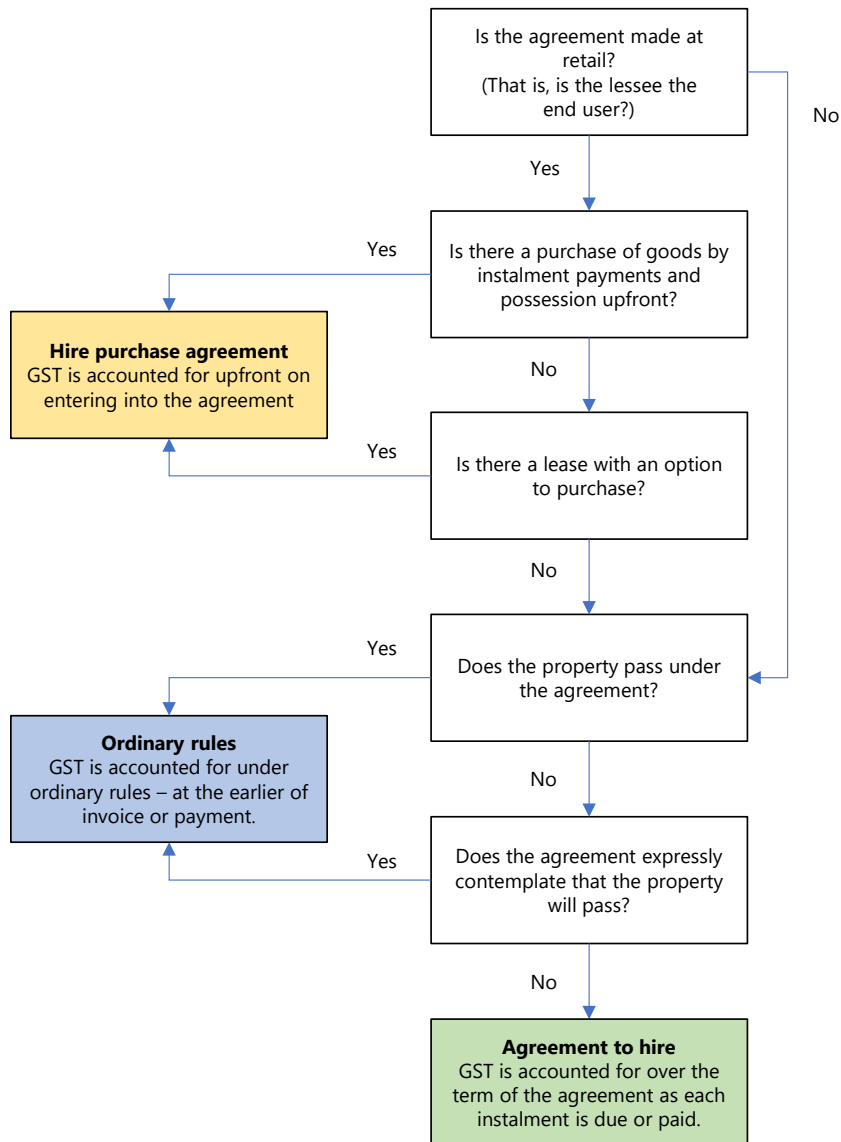
108. To apply the time of supply rules, it is necessary to correctly classify a finance lease as:
- an agreement to hire;

- a hire purchase agreement; or
- as falling outside these definitions, so a third category agreement.

109. The classification determines whether GST is chargeable upfront or over the term of the lease. For GST purposes, an agreement has only one legal classification that determines its treatment under the Act for both parties to that agreement. Accordingly, both parties to a lease must adopt the same timing treatment.

110. The process for classifying finance leases for time of supply is summarised in Flowchart 1 – Classifying finance leases for time of supply which is reproduced here for convenience.

Flowchart 2 – Classifying finance leases for time of supply



Classifying finance leases – value of supply

111. Section 10 determines the value of any supply. The general rule is that the value of a supply is the GST-exclusive consideration paid for it. However, under s 10(5) and (5A)–(5C) there is an exception to this general rule for supplies made under a credit contract:

10 Value of supply of goods and services

...

- (5) Despite subsection (2), if a supply of goods and services is made under a credit contract, the consideration in money for the supply is treated as being the higher of the cash price of the goods and services and the price the supplier would have charged the purchaser if the purchaser had paid in full at the time the credit contract was entered into.

- (5A) In subsection (5),—

cash price has the same meaning as in section 5 of the Credit Contracts and Consumer Finance Act 2003

credit contract has the same meaning as in section 3 of the Credit Contracts Act 1981 immediately before the repeal of that Act.

- (5B) Despite subsection (5A), a person who is a party to an arrangement that is a credit contract but is not a credit contract under section 7 of the Credit Contracts and Consumer Finance Act 2003 may elect that the arrangement be treated under this section as not being a credit contract in relation to the person.

- (5C) Despite subsection (5A), a person who is a party to an arrangement that is not a credit contract but is a credit contract under section 7 of the Credit Contracts and Consumer Finance Act 2003 may elect that the arrangement be treated under this section as being a credit contract in relation to the person.

112. The exception excludes any interest and finance charges from GST when a supply is made under a credit contract. Under s 10(5), GST is payable on only that part of the consideration equivalent to the “cash price” or, if higher, the price that customer would have been charged if they had paid in full upfront. The reason for the exception is that providing credit under a credit contract is a financial service and the supply of any financial services is generally exempt from GST (ss 3(1)(f) and 14(1)(a)). Interest or finance charges can also be zero-rated under s 11A(1)(q) if the requirements of that section are met.
113. Accordingly, to determine the value of a supply, it first needs to be determined whether the relevant lease is a credit contract and subject to the exception. If the finance lease is a “credit contract”, the “cash price” then needs to be determined. When a lease is not a credit contract, ordinary value of supply rules apply and the total amount payable under the lease is subject to GST.

Finance leases that are credit contracts

114. A finance lease can be a credit contract regardless of whether the finance lease is a hire purchase agreement, an agreement to hire or a third category agreement.
115. The definition of "credit contract" in the GST Act is interesting as it refers to a definition in a repealed Act. The Credit Contracts Act 1981 (CCA) was repealed and replaced by the Credit Contracts and Consumer Finance Act 2003 (CCCFA). Section 10(5A) in the GST Act defines credit contract by referring to the CCA, but ss 10(5B) and 10(5C) permit persons party to a credit contract under the CCA to elect that the definition of credit contract under the CCCFA applies instead.¹⁷
116. Therefore, we consider the default position under the definition from the CCA first, then choices available to use the CCCFA. For ease of reference, s 3 of the CCA as it was immediately before the repeal of that Act is set out in the Appendix to this item.

Credit contracts under the Credit Contracts Act 1981

117. The meaning of "credit contract" in s 3 of the CCA (immediately before the Act's repeal) includes:

3 Meaning of "credit contract"

(1) ...

(d) A contract under which a person sells or agrees to sell property or provides or agrees to provide services (whether or not possession of the property is given, or the services are provided, before all money payable under the contract has been paid) in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the sale or provision, a sum or sums of money exceeding in aggregate the cash price of the property or services; and

(e) A contract under which a person bails or agrees to bail goods (whether or not with an option to purchase) in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the bailment or option, a sum or sums of money exceeding in aggregate the cash price of the goods;

(2) In subsection (1) of this section, the term "promise" includes a conditional promise.

118. Finance leases will generally be credit contracts under the definition in the CCA. This is because the amount payable under the lease will usually exceed the cash price of the leased goods.

¹⁷ These provisions are reflected in s 3(2), (3B) and (3C) of the CCA, which define financial services.

119. A finance lease which is a purchase of goods by instalment payments will generally be a credit contract under paragraph (d). Other lease arrangements which are used as a financing tool will generally be credit contracts under paragraph (e).
120. Two aspects of the definition in paragraph (e) should be noted. First, options are specifically referred to. Included in the definition are payments made in respect of options. Secondly, as a "promise to pay" includes a conditional promise, the Commissioner considers any payments relating to residual value clauses under a finance lease need to be included. Although a guaranteed residual value is not referred to explicitly in s 3(1)(e) of the CCA, the potential liability of a lessee to pay an amount up to the residual value at the end of a lease is a conditional promise to pay money in the future for the lease. This means when calculating whether the amount payable under the lease exceeds the cash price, the following amounts are included in the amount payable:
- the exercise price of an option; and
 - any guaranteed residual value.

Credit contracts under the Credit Contracts and Consumer Finance Act 2003

121. As noted above, the parties to a credit contract arrangement can elect to apply the definition of "credit contract" in s 7 of the CCCFA to a particular arrangement instead of the definition in the CCA. The ability to elect to apply the CCCFA is available if the treatment under the CCCFA is different from the treatment under the CCA. Section 7 of the CCCFA states:

7 Meaning of credit contract

- (1) In this Act, unless the context otherwise requires, **credit contract** means a contract under which credit is or may be provided.
- (2) If, because of any contract or contracts (none of which by itself constitutes a credit contract) or any arrangement, there is a transaction that is in substance or effect a credit contract, the contract, contracts, or arrangement must, for the purposes of this Act, be treated as a credit contract made at the time when the contract, or the last of those contracts, or the arrangement, was made, as the case may be.

122. For a finance lease to be a credit contract under the CCCFA, "credit" needs to be provided under the contract. Credit is defined in s 6 of the CCCFA.

6 Meaning of credit

In this Act, unless the context otherwise requires, **credit** is provided under a contract if a right is granted by a person to another person to—

- (a) defer payment of a debt; or
- (b) incur a debt and defer its payment; or
- (c) purchase property or services and defer payment for that purchase (in whole or in part).

123. The definition of “credit” under the CCCFA has three limbs, but essentially the contract must defer a payment of a debt. The two elements to this requirement are:
- there must be a debt; and
 - the payment of that debt must be deferred.
124. Whether a particular arrangement is a credit contract under this definition will depend on the terms of the contract. Some finance leases may not defer the payment of debt. It may be that each payment becomes due and payable when required under the lease. The argument is that the total amount of the lease payments is not due on day one of the lease with the payments deferred over the term of that lease. The argument continues that each payment becomes due on the continuing lease or hire of the goods. Because of this, there is no deferral of a debt.
125. If a particular arrangement is a credit contract under the CCA (because total payments due exceed the cash price) but is not a “credit contract” under the CCCFA (because there is no deferral of a debt), the parties can choose to apply the definition in the CCCFA. In this case, the finance lease will not be a credit contract for GST purposes.
126. The reverse situation can also apply. If a particular arrangement is not a credit contract under the CCA but is a credit contract under the CCCFA, the parties can choose to apply the definition in the CCCFA so that the arrangement is treated as a credit contract. This situation will not occur frequently as the definition of “credit contract” in the CCCFA appears to be narrower than the definition in the CCA.
127. Accordingly, whether a finance lease is a credit contract is determined in the first instance by the definition of credit contract in the CCA. If the treatment is different under the CCCFA, the parties can choose to apply the definition in the CCCFA.
128. In some situations, taxpayers may have updated their standard lease contracts to comply with the definition of “credit contract” in the CCCFA. If it is clear from the terms of the contract that the lease is a credit contract under the CCCFA, then the Commissioner will not generally require the parties to also show whether the arrangement is a credit contract under the CCA.

Making an election

129. Where it is desired that the definition of “credit contract” in the CCCFA should apply, it is the Commissioner’s view that both parties to the finance lease must treat the agreement in the same way. Arguably, the words “in relation to the person” in s 10(5B) and (5C) could be interpreted as allowing the parties to an arrangement to elect to treat the arrangement differently from each other.
130. However, only one contract exists (irrespective of whether there is a single supply or the GST Act deems there to be successive supplies) and that contract cannot have different GST treatments for the parties to the contract. The Commissioner’s view of these sections is that any party to an arrangement may decide the treatment, but if the parties are of different minds, only one party can prevail – and this is likely to be the supplier or lessor. This is part of the negotiation process and, ultimately, the contract and tax invoice(s) need to reflect the agreed position.
131. The GST Act does not specify how to elect to apply the definition of “credit contract” in the CCCFA to a particular arrangement. The Commissioner accepts that parties to a finance lease can make this election by adopting the relevant treatment in the written contract and tax invoice(s), and filing their GST returns accordingly.

Determining the value of supply under s 10(5)

132. Having determined whether the finance lease is a credit contract, the value of the supply can be determined.
133. If a finance lease is not a credit contract, GST applies to the total amount payable under the lease because there are no implied finance and interest charges. No “credit” is provided, and the transaction is taxed in full at 15%. Parties to a finance lease might elect this treatment under the CCCFA as a means of simplifying the GST treatment of the finance lease.
134. If a finance lease is a credit contract, GST is payable only on that part of the consideration equivalent to the “cash price” or, if higher, the price that customer would have been charged if they had paid in full upfront (s 10(5)). Generally the cash price is the same as the price the customer would have been charged but for the credit contract. However, in some cases (for example when a supplier has both retail and wholesale customers), these amounts might be different. For more information see *Tax Information Bulletin* Vol 12, No 12, December 2000 at 22 “*Consideration for a supply under a credit contract*”. “Cash price” is defined in s 5 of the CCCFA:

cash price, in relation to property sold or leased, or to services provided under a contract, means—

- (a) the lowest price at which a person could have purchased that property or those services from the vendor, lessor, or provider on the basis of payment in full at the time the contract was made; or
- (b) if there is no price in accordance with paragraph (a), the fair market value of that property or those services at the time the contract was made.

135. The “cash price” is usually specified in the contract. When there is doubt that the cash price stated in the contract is the true cash price, the lowest price at which a person could have purchased the leased goods outright from the lessor at the time the lease was entered into should be used. If that price is not known, then the fair market value of the leased goods at the time the lease was entered should be used.
136. Once the cash price has been determined, GST is payable only on that part of the consideration equivalent to the “cash price” or, if higher, the price that customer would have been charged if they had paid in full upfront. The difference between the cash price (or higher amount) and the total consideration payable under the finance lease is consideration for providing credit under a credit contract that is a financial service and exempt from GST (ss 3(1)(f) and 14(1)(a)) or zero-rated (s 11A(1)(q)).

Summary

137. Generally, finance leases will be credit contracts under the CCA. This is because the amount payable under the lease will exceed the cash price of the leased goods. In these cases, GST is chargeable on only the cash price component of the total consideration payable over the term of the lease (or if higher, the price that customer would have been charged if they had paid in full upfront).
138. However, the parties to a finance lease can elect to apply the definition in the CCCFA. This election may mean the finance lease is treated as not being a credit contract. If the finance lease is not a credit contract, GST is chargeable on the total amount payable under the lease (because there is no implied interest or finance component).
139. Where the definition of “credit contract” in the CCCFA is sought to be applied, the Commissioner’s view is that both parties to the finance lease must treat the arrangement in the same way. The contract and tax invoice(s) should reflect the agreed position. See Example 14.

Example 14 – Finance lease that is a credit contract under Credit Contracts Act 1981

Standout Painter Ltd decides to get a car on finance from Dealer Ltd to use in Standout Painter Ltd's taxable activity. Finance Co Ltd provides finance. Both parties are GST registered. The cash price of the car is \$46,000, including GST of \$6,000. The term of the lease is 5 years with 60 equal monthly payments to be made. The lease has a residual value of \$1. The total interest charges for the term of the lease are \$10,000.

The lease is a credit contract under the CCA because the amount payable under the lease is more than the cash price of the car. Both Finance Co Ltd and Standout Painter Ltd are happy with this position and do not consider the position under the CCCFA. The contract states the cash price (which is also the price Standout Painter Ltd would have paid if Standout Painter Ltd had paid in full upfront and not entered into a finance lease). To avoid subsequent debate, Finance Co Ltd puts a clause in the contract that states the lease is a credit contract for GST purposes.

GST is chargeable on only the cash price component of the total amount payable over the term of the lease.

Accounting for GST on finance leases

140. Having classified finance leases for time of supply purposes and determined whether they are credit contracts for value of supply purposes, it is then necessary to determine how to account for GST on finance leases. As would be expected, how to account for GST on a finance lease depends on whether the lease is:
- a hire purchase agreement, an agreement to hire or a third category agreement (for time of supply purposes); and
 - a credit contract (for value of supply purposes).
141. Once a finance lease has been classified for both time and value of supply purposes, any special rules can be applied to determine when and how much GST to return or claim. We discuss the accounting treatment and special rules for each type of finance lease. Hire purchase agreements and third category agreements are considered first as they are treated similarly.

Hire purchase agreements

142. A finance lease will be a hire purchase agreement, if the lessee is the end user of the goods and:
- the lessor gives the lessee an option to purchase (see [46] – [67]); or
 - the agreement is a purchase of goods by instalment payments (see [68] – [73]).
143. When a finance lease is a hire purchase agreement, the time of supply is deemed to be the time the agreement is entered into (s 9(3)(b)).
144. If the lease is a hire purchase agreement and a credit contract, GST is chargeable on only the cash price component of the total consideration payable over the term of the lease (or if higher, the price that customer would have been charged if they had paid in full upfront). The difference between the total consideration payable under the finance lease and the cash price is treated as a financial service and exempt from GST (s 10(5)), unless it can be zero-rated (s 11A(1)(q)). Accordingly, GST is generally 3/23 of the cash price of the leased goods, accounted for at the time the agreement is entered into.
145. If the lease is a hire purchase agreement and not a credit contract, then GST is chargeable on the full consideration of the leased goods (because there is no implied interest or finance component) (s 10(2)). The consideration includes an amount that is payable if an option to purchase is exercised. Accordingly, GST is 3/23 of the full consideration of the leased goods, accounted for at the time the agreement is entered into. This is illustrated in Example 15.

Option not exercised

146. If the agreement is a finance lease with an option to purchase and that option is not exercised, an adjustment may need to be made to the consideration and a credit note issued. When this happens, the nature of the supply has been fundamentally varied or altered so any credit note should be issued under s 25(1)(aa) (or s 19N from 1 April 2023).
147. The GST Act treats a hire purchase agreement effectively as a sale by requiring the supplier to account for GST at the time the hire purchase agreement is entered into. It expects that the option will be exercised and ownership of the goods will transfer to the lessee. If the option is not exercised, ownership of the goods remains with the lessor and the lessee has merely rented the goods. This is illustrated in Example 16.

Example 15 – Hire purchase agreement and credit contract – option exercised

Uearth Ltd is a GST-registered company that needs some specialised plant to use in its taxable activity. Uearth Ltd leases the machinery from Finance Co Ltd with an option to purchase. The cash price is \$80,500 inclusive of GST of \$10,500. The term of the lease is 36 months. Total lease payments are \$56,000, including finance charges of \$10,000. The payment to buy the machine at the end of the lease is \$34,500. At the end of the lease, Uearth Ltd exercises the option to purchase for \$34,500.

The agreement is a hire purchase agreement and a credit contract. Finance Ltd must return output tax of \$10,500 at the time the agreement is entered into. Uearth Ltd can claim an input tax credit of \$10,500 at the time the agreement is entered into. No further GST is payable when the option is exercised. GST has been accounted for correctly on the cash price as required.

Example 16 – Hire purchase agreement and credit contract – option not exercised

This is a variation on Example 15. The facts are the same as in Example 15, except at the end of the lease, Uearth Ltd decides not to exercise the option to purchase and returns the machine to Finance Ltd.

Finance Ltd issues a credit note showing that the correct amount of GST to pay on the lease is \$6,000 (that is, the cash price for leasing the machine of \$46,000 x 3/23).

Third category agreements

148. A finance lease will generally be a third category agreement if the lessee is not the end user of the goods and the goods will eventually definitely pass to the lessee under the terms of the agreement.
149. When a finance lease is a third category agreement the GST outcome is similar to that for a hire purchase agreement. However, the time of supply is the earlier of the time the supplier issues an invoice or receives a payment for that supply (s 9(1)).
150. Accordingly, if the agreement is a credit contract, GST is 3/23 of the cash price of the leased goods, accounted for at the earlier of the time the supplier issues an invoice or receives a payment for that supply. If the agreement is not a credit contract, GST is 3/23 of the full consideration of the leased goods, accounted for at the earlier of the time the supplier issues an invoice or receives a payment for that supply.

Agreement to hire and a credit contract

151. In many cases, a finance lease is an agreement to hire for GST purposes. When a finance lease is an agreement to hire, the goods are treated as being successively supplied. Each successive supply is treated as taking place at the earlier of when a payment becomes due or is received.
152. When a finance lease is also a credit contract, s 10(5) deems GST to be payable on only that part of the consideration that is equivalent to the cash price. GST applies to only the non-interest and finance charge elements of the consideration; that is, the principal component.
153. The combined effect of the “special” time and value of supply rules is that the GST payable under a finance lease that is an agreement to hire and a credit contract is $\frac{3}{23}$ of the GST-inclusive cash price of the leased goods, spread over the payments to be made over the term of the lease.
154. To determine how much GST to account for on each payment, it is necessary to determine the principal component of each payment. That is the amount being paid for the supply of the use of the goods rather than for the exempt supply of financial services. The amount of principal and interest or finance charges included in each payment is usually determined using the actuarial method (or an allowable spreading method for income tax purposes). Generally, the amounts of principal and interest will vary for each payment with the principal increasing and the interest decreasing over the term of the finance lease. The principal is a GST-exclusive amount, so GST is 15% of the principal component of each payment. Using an actuarial method means a different amount of GST will apply to each lease payment as illustrated in Example 17.

Example 17 – GST calculated on an actuarial basis

On 1 March 2021, Finance Co Ltd leases a photocopier to Mikaere’s Business Ltd for use in its office. The term of the lease is 3 years. The cash price of the photocopier is \$5,750, including GST of \$750. The finance charges amount to \$1,000. Lease payments are due quarterly in advance. The finance company determines the amount of principal and interest in each payment actuarially. It calculates GST on the principal component of each payment. The payments schedule looks like this:

Due date	Rental (\$)	Principal (\$)	Interest (\$)	GST (\$)	Total due (\$)
1/03/2021	500.00	500.00	0.00	75.00	575.00
1/06/2021	500.00	342.50	157.50	51.38	551.38
1/09/2021	500.00	354.49	145.51	53.17	553.17
...
1/12/2023	500.00	483.13	16.87	72.47	572.47
	6,000.00	5,000.00	1,000.00	750.00	6,750.00

155. Because the amount of GST varies from payment to payment, there may be administrative difficulties for parties to finance leases. For example, it may be difficult to set up automatic payment facilities as the payment amount would not be the same. The use of an actuarial basis may also result in lessees incorrectly claiming input tax deductions based on 3/23 of each payment, rather than 15% of the principal component of each payment.
156. To avoid these problems the Commissioner in practice accepts GST being returned on a straight-line basis as an alternative to using an actuarial method (or allowable spreading method for income tax purposes). Under the straight-line method, the GST payable under a finance lease is spread evenly over the rental payments. The same amount of GST must be returned and is available to be claimed as an input tax deduction on each rental payment. This is illustrated in Example 18.

Example 18 – GST calculated on a straight-line basis

Using the facts from Example 17 but accounting for GST on a straight-line basis, the payments schedule looks like this:

Due date	Rental (\$)	Principal (\$)	Interest (\$)	GST (\$)	Total due (\$)
1/03/2021	500.00	500.00	0.00	62.50	562.50
1/06/2021	500.00	342.50	157.50	62.50	562.50
1/09/2021	500.00	354.49	145.51	62.50	562.50
...
1/12/2023	500.00	483.13	16.87	62.50	562.50
	6,000.00	5,000.00	1,000.00	750.00	6,750.00

Tax invoices

157. For a finance lease that is an agreement to hire and a credit contract, GST is accounted for over the term of the lease on an actuarial or straight-line basis. Under s 24(3)(g) (or s 19E from 1 April 2023), the tax invoice(s) for a finance lease must indicate what part of each payment made under the lease is attributable to GST. Lessors must return GST on the basis set out in the tax invoice. If GST-registered lessees who acquire leased goods for use in their taxable activity are claiming an input tax deduction, they must do so on the basis set out in the tax invoice.

Residual value clauses

158. The nature of a residual value clause is considered from [60]. The residual value payments made at the end of a finance lease affect the total amount of GST payable under the finance lease. If the lessee retains the leased goods and pays the residual value (including GST), the full amount of GST payable on the finance lease (as determined by reference to the “cash price” at the start of the lease) is returned. However, this is not the position when the lessee returns the leased goods.
159. If the leased goods are returned and sold (or valued), certain adjustments to the consideration paid by the lessee are usually required under the residual value clause of the finance lease. For GST purposes, these adjustments may require the lessor to issue a credit note to reflect the fact consideration for the supply of the leased goods has been altered under s 25(1)(b) (or s 19N from 1 April 2023).
160. This treatment applies to all payments made under residual value clauses, regardless of whether a finance lease terminates at the end of its term or earlier by agreement between the parties or due to the lessee’s default. See Example 19.

Example 19 – Residual value – GST calculated on a straight-line basis

Krazy Kakes Ltd leases a vehicle from Finance Co Ltd for use in its taxable activity. Both parties are GST registered. The cash price of the vehicle is \$46,000, including GST of \$6,000. The lease is for a three-year term, with 36 equal monthly rental payments. The finance charges total \$10,000. The lease provides the following:

- The lessor remains the owner of the vehicle.
- At the end of the lease, the lessee must return the vehicle and pay the residual value of \$13,800 (including GST of \$1,800) less the net sale proceeds of the vehicle. If the vehicle sells for more than the residual value, the lessor must pay the excess to the lessee.
- If the lessee does not return the vehicle to the lessor, the lessee must pay the full residual value.

Finance Co Ltd issues a tax invoice for the lease setting out the lease payments and the GST charged on each payment. The tax invoice indicates that GST is to be returned over the term of the lease on a straight-line basis.

The following table summarises the financial terms of the lease.

	GST-exclusive amount (\$)	GST (\$)	GST-inclusive amount (\$)
Cash price	40,000	6,000	46,000
Finance charges	10,000	-	10,000
Total	50,000	6,000	56,000
<i>Less residual value</i>	12,000	1,800	13,800
Total monthly rental payments	38,000	4,200	42,200
<i>Divide by 36 months</i>			
Monthly payments	1,055.55	116.66	1,172.21

The lease is an agreement to hire and a credit contract. It is not a hire purchase agreement because although Krazy Kakes Ltd is the end user of the vehicle, it does not include an option to purchase. It is a credit contract because the consideration payable over the term of the lease exceeds the cash price of \$46,000.

The GST treatment at the end of the lease is explained in the following three scenarios.

Scenario 1 – Krazy Kakes Ltd returns the vehicle – shortfall on sale

Krazy Kakes Ltd leases the vehicle for the full three-year term and returns the vehicle to Finance Co Ltd at the end of the lease. Finance Co Ltd sells the vehicle at auction for

\$11,500 (including GST). After deducting the auction expenses (excluding GST), the net sale proceeds are \$10,350. The terms of the lease require Crazy Kakes Ltd to pay to Finance Co Ltd the shortfall between the residual value and the net sale proceeds (that is, \$3,450):

	GST-exclusive amount (\$)	GST (\$)	GST-inclusive amount (\$)
Finance Co Ltd sale at auction	10,000	1,500	11,500
Less auction expenses	1,000	150	1,150
Net sale proceeds	9,000	1,350	10,350
Residual value	12,000	1,800	13,800
Shortfall to Finance Co Ltd	3,000	450	3,450

The GST treatment is as follows:

- Finance Co Ltd issues a credit note to Crazy Kakes Ltd, stating that the correct amount of GST still to pay on the lease is \$450 (3/23 of \$3,450).
- Crazy Kakes Ltd pays a further \$3,450 to Finance Co Ltd.
- Crazy Kakes Ltd claims a \$450 input tax deduction.
- Finance Co Ltd returns \$450 output tax on the lease.
- Finance Co Ltd issues a tax invoice on the sale of the vehicle.
- Finance Co Ltd returns \$1,500 output tax on the sale of the vehicle (3/23 of \$11,500).

Therefore, the lessee has an input tax deduction of \$450. Finance Co Ltd pays output tax of \$1,950. The overall result is a further \$1,500 output tax (3/23 of sale proceeds).

Scenario 2 – Crazy Kakes Ltd returns the vehicle – surplus on sale

Krazy Kakes Ltd leases the vehicle for the full three-year term and returns it to Finance Co Ltd at the end of the lease. Finance Co Ltd sells the vehicle through a private sale for \$17,250 (including GST). After deducting the sale expenses (excluding GST) the net sale proceeds are \$16,100. There is no shortfall between the residual value and the net sale proceeds, so Crazy Kakes Ltd is not required to pay anything further to Finance Co Ltd. The terms of the lease require Finance Co Ltd to pay to Crazy Kakes Ltd the difference between the net sale proceeds and the residual value:

	GST-exclusive amount (\$)	GST (\$)	GST-inclusive amount (\$)
Finance Co Ltd private sale	15,000	2,250	17,250
Less auction expenses	1,000	150	1,150
Net sale proceeds	14,000	2,100	16,100
Residual value	12,000	1,800	13,800
Surplus to Finance Co Ltd	2,000	300	2,300

The GST treatment is as follows:

- Krazy Kakes Ltd pays nothing further to Finance Co Ltd.
- Finance Co Ltd issues a tax invoice on the sale of the vehicle.
- Finance Co Ltd returns \$2,250 output tax on the sale of the vehicle (3/23 of \$17,250).
- Finance Co Ltd pays \$2,300 to Krazy Kakes Ltd (the excess of the net sale proceeds over the residual value). This reflects a reduction to the consideration agreed for the lease.
- Finance Co Ltd issues a credit note stating that the correct amount of GST to pay on the lease is \$3,900 (\$4,200 less 3/23 of \$2,300).
- Krazy Kakes Ltd returns output tax of \$300.
- Finance Co Ltd claims an input tax deduction of \$300.

Therefore, Krazy Kakes Ltd returns \$300 output tax. Finance Co Ltd pays output tax of \$2,250 and claims an input tax deduction of \$300. The overall result is a further \$2,250 output tax (that is, 3/23 of the proceeds of sale).

Scenario 3 – Krazy Kakes Ltd keeps the vehicle and pays the residual value

Krazy Kakes Ltd leases the vehicle for the full three-year term and decides to keep the vehicle at the end of the lease. The terms of the lease require Krazy Kakes Ltd to pay to Finance Co Ltd the full residual value.

The GST treatment is as follows:

- Krazy Kakes Ltd pays a further \$13,800 to Finance Co Ltd (by virtue of its obligation to pay the residual value).
- Krazy Kakes Ltd claims an input tax deduction of \$1,800 (with reference to the tax invoice issued by the lessor at the time of entering into the lease).

- Finance Co Ltd returns \$1,800 output tax on the lease.

Therefore, Krazy Kakes Ltd claims a further \$1,800 input tax. Finance Co Ltd pays a further \$1,800 output tax.

On termination of the lease, Krazy Kakes Ltd negotiates with Finance Co Ltd to buy the vehicle. Finance Co Ltd agrees to transfer title to the vehicle for a further \$115 administration charge (including GST of \$15). Accordingly:

- Finance Co Ltd returns \$15 output tax on the sale; and
- Krazy Kakes Ltd claims an input tax deduction of \$15.

Not a credit contract

161. When a finance lease is an agreement to hire and not a credit contract, GST is chargeable on the full consideration of the leased goods (because there is no implied interest or finance component) (s 10(2)). Accordingly, GST is 3/23 of the full amount of each lease payment, accounted for each time a payment is due or received (whichever is earlier).

Summary

162. Hire purchase agreements and third category agreements are treated in a similar way. If they are credit contracts, GST is generally 3/23 of the cash price of the leased goods, payable upfront. If they are not credit contracts, GST is 3/23 of the full consideration of the leased goods, payable upfront. If an option to purchase is not exercised, an adjustment may need to be made to the consideration and a credit note issued.
163. When a finance lease is an agreement to hire and a credit contract, GST is accounted for over the term of the lease each time a payment is due or received (whichever is earlier) generally by reference to the cash price. The interest and finance components of the lease payments are exempt from GST (unless zero-rated under s 11A(1)(q)).
164. To determine the cash price of each payment the lessor calculates the principal and interest components of each payment on an actuarial basis. GST is 15% of the principal component of each payment. This method generally results in a different amount of GST for each payment.
165. To ease compliance, the Commissioner accepts a straight-line method to spread GST evenly over the term of the lease. This approach does not require any reference to the principal component of each payment but simply spreads the GST on the cash price evenly over the lease payments.

166. An exception to this approach arises where the finance lease is a residual value lease. In this case, GST applies in full to the difference between the cash price and the residual value and is spread evenly over the rental payments. GST on any payment(s) made under the residual value clause is accounted for at the end of the lease. This approach accounts for any potential adjustments to the consideration because of the residual value clause. It is also consistent with the approach to agreements to hire under s 9(3)(a) of accounting for GST on the actual payments made.
167. Lessors must return output tax on the basis set out in the tax invoice. GST-registered lessees who acquire the goods for use in their taxable activity can claim input tax deductions only on the same basis as the lessor, being as set out in the tax invoice.
168. When a finance lease is an agreement to hire and not a credit contract, GST is 3/23 of each lease payment made over the term of the lease.

Agency issues on selling goods

169. Issues have arisen about the GST consequences of supplies when a lessee sells the goods as agent for a lessor at the end of finance leases. This situation can be further complicated where residual value clauses exist.
170. The law relating to issues of GST and agency is set out in "[IS 21/01: GST and agency](#)", *Tax Information Bulletin* Vol 33, No 2 (March 2021): 21. The following analysis reproduces parts of and is consistent with that analysis.

General rule

171. Section 60 is the main provision in the Act that deals with agency. The general rule is that where a person acts as an agent in making a supply on behalf of a principal, the supply is deemed to be made by the principal and not by the agent (s 60(1)). Consequently, the principal, not the agent, must account for GST on that supply. The principal is responsible for complying with its GST obligations, including issuing a tax invoice and any related credit or debit notes.
172. However, where the supply is a taxable supply, the proviso to s 60(1) allows a GST-registered agent to issue a tax invoice for the supply (or a credit or debit note if required) as if the agent had made the taxable supply. If the agent is not GST registered, it cannot issue a tax invoice. Agents who issue tax invoices, credit notes or debit notes in these situations must comply with the record-keeping requirements in the Act. Where an agent issues a tax invoice or a credit or debit note (under s 60(1) or s 60(2)), the agent must maintain sufficient records to enable the name, address and

registration number (if any) of the principal to be ascertained (s 60(3)). The principal must account for the GST on the tax invoice, credit note or debit note.

173. The time of supply rules in s 9 apply to principals and agents. Therefore, a principal must account for GST when the time of supply is triggered. In some cases, the principal might not be aware that an agent has made a sale on the principal's behalf, triggering the time of supply. Agents and principals must have appropriate systems in place so the principal is notified of the sale and can account for GST correctly.
174. The agent is usually required to notify the principal of the price at which goods are sold. Similarly, the agent is usually required to reveal the identity of the principal's customers.
175. In summary, if a lessee sells the leased goods as agent for the lessor, the supply is deemed to be made by the lessor. The lessor must account for GST even if the lessee issues the tax invoice for the supply. The lessee is required to notify the lessor of the sale and provide sufficient information for them to account for GST correctly. See Example 20.

Alternative approach if treated as separate supplies

176. An alternative to the general rule is provided under the Act (s 60(1B)). Where an agent makes a supply to a third party on behalf of a principal, the principal and the agent can agree to treat the supply as two separate supplies:
 - a supply of goods and services from the principal to the agent; and
 - a supply of those goods and services from the agent to the third party.

60 Agents and auctioneers

...

- (1B) Despite subsection (1), when a principal and their agent agree, and record their agreement in a document, either in relation to a particular supply or for a type of supply, that this subsection applies to a supply of goods or services, the supply is treated for the purposes of the Act as 2 separate supplies, being—
- (a) a supply of goods and services from the principal to the agent; and
 - (b) a supply of those goods and services from the agent to the recipient, treating the agent as if they were the principal for the purpose of the supply.

177. Section 60(1B) was introduced because some accounting systems automatically issue invoices when goods and services are supplied. For example, the principal's accounting system might issue a tax invoice when goods and services are provided to

the agent and the agent's accounting system might also issue a tax invoice when goods and services are provided to the third party.

178. The principal and the agent can agree that the supply is to be treated as two separate supplies. The agreement must be recorded in a document. The agreement may relate to a particular supply or a type of supply. Two separate invoices can then be issued without contravening the Act. The principal then returns output tax on the tax invoice issued to the agent. Likewise, the agent returns output tax on the tax invoice issued to the third party and can claim input tax being the output tax charged to them by the principal. This is illustrated in Example 21.

Example 20 – Lessee sells goods and entitled to sale proceeds over guaranteed residual value

Finance Co Ltd leases a vehicle to Showy Showers Ltd. Finance Co Ltd retains ownership of the vehicle throughout the term of the agreement. Under the agreement, there is a guaranteed residual value of \$10 and Showy Showers Ltd is entitled to keep any sales proceeds over the guaranteed residual value. Showy Showers Ltd retains possession of the vehicle at the end of the lease and sells it on behalf of Finance Co Ltd in accordance with the finance lease. The vehicle sells for \$5,000 to a third party.

Showy Showers Ltd sold the vehicle as agent for Finance Co Ltd. Either Showy Showers Ltd or Finance Co Ltd must issue a tax invoice for the sale to the third party. However, Finance Co Ltd must account for the output tax on the sale proceeds of \$5,000.

Showy Showers Ltd is entitled to receive \$4,990 of the sale proceeds. This is treated as a reduction to the consideration agreed for the lease. Finance Co Ltd issues a credit note for \$4,990 and can claim an input tax deduction for GST on \$4,990. Showy Showers Ltd is required to return output tax on \$4,990.

Example 21 – Parties treat as two supplies

This is a variation on Example 20. The facts are the same as in Example 20 except Finance Co Ltd agrees with Showy Showers Ltd (and sends Showy Showers Ltd an email to that effect) that the sale of the vehicle to the third party should be treated as two supplies. Therefore, Finance Co Ltd issues a tax invoice for the sale price of \$5,000 to Showy Showers Ltd, and Showy Showers Ltd issues a tax invoice for \$5,000 to the third party. Finance Co Ltd returns GST output tax on the invoice to Showy Showers Ltd, while Showy Showers Ltd returns GST output tax on the invoice to the third party, but can claim an input tax deduction on the invoice from Finance Co Ltd.

Finance Co Ltd and Showy Showers Ltd must account for the return of the \$4,990 sale proceeds to Showy Showers Ltd in the same manner as Example 20.

Appendix

Credit Contracts Act 1981 (repealed)

3 Meaning of "credit contract"

(1) In this Act, the term "credit contract" means -

- (a) A contract under which a person provides or agrees to provide money or money's worth in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the provision, a sum or sums of money exceeding in aggregate the amount of the first-mentioned money or money's worth; or
- (b) A contract under which a person forbears or agrees to forbear from requiring payment of money owing to him in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the forbearance, a sum or sums of money exceeding in aggregate the amount of the first-mentioned money;

and, without limiting the generality of paragraphs (a) and (b) of this subsection, includes -

- (c) A contract under which a person lends or agrees to lend money in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the loan, a sum or sums of money exceeding in aggregate the amount of the loan; and
- (d) A contract under which a person sells or agrees to sell property or provides or agrees to provide services (whether or not possession of the property is given, or the services are provided, before all money payable under the contract has been paid) in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the sale or provision, a sum or sums of money exceeding in aggregate the cash price of the property or services; and
- (e) A contract under which a person bails or agrees to bail goods (whether or not with an option to purchase) in consideration of a promise by another person to pay, or to procure the payment of, in the future and in respect of the bailment or option, a sum or sums of money exceeding in aggregate the cash price of the goods; and
- (f) A contract under which a person releases or assigns or agrees to release or assign (whether absolutely or by way of mortgage), with recourse upon himself, a right to receive money in the future in consideration of a promise by another person to pay a lesser sum of money either immediately or at a time earlier than the maturity of the released or assigned right;

but, subject to subsection (4) of this section and to section 4 of this Act, does not include -

- (g) A contract of indemnity against loss or a policy within the meaning of section 41 of the Life Insurance Act 1908; or
- (h) A lease of, or an agreement to lease, any real property (whether with or without an option to purchase); or
- (i) A contract for the sale of property, or the provision of services, to a person if the total amount payable under the contract by the person (other than any amount payable solely as a result of a default in payment by him) is the agreed price of the property or services and is to be paid within 2 months from the date the contract is made.

- (2) In subsection (1) of this section, the term "promise" includes a conditional promise.
- (3) For the purposes of determining whether a contract is a credit contract within the meaning of this section,
 - (a) Incidental services provided pursuant to the contract, and legal services relating to the contract, shall not be included as money's worth provided, or agreed to be provided, under the contract; and
 - (b) The following amounts shall not be included as part of the sum or sums of money promised to be paid in the future:
 - (i) Any reasonable amount payable for incidental services to the promisor, or for incidental services to any property sold or bailed under the contract or over which security is taken by or pursuant to the contract:
 - (ii) Any reasonable amount payable as a result of a default under the contract by the promisor:
 - (iii) Any reasonable amount payable as a result of damage to property while in the possession of the promisor:
 - (iv) Any reasonable amount payable for surveys, inspections, or valuations of property required for the purposes of the contract:
 - (v) Any reasonable amount payable for legal services relating to the contract (other than for the collection of money):
 - (vi) Any amount required to be paid by virtue of any enactment:
 - (vii) In the case of a contract of bailment where the bailee has the right to cancel the bailment, any amounts that cease to be payable under the contract upon the bailee exercising that right:
 - (viii) Any amount of a kind specified in regulations made under section 47 (1) (a) of this Act.
- (4) Where, by virtue of any contract or contracts (none of which by itself constitutes a credit contract) or any arrangement, there is a transaction that is in substance or effect a credit contract, the contract, contracts, or arrangement shall for the purposes of this Act be deemed to be a credit contract made at the time when the contract, or the last of those contracts, or the arrangement, was made, as the case may be.

References

Legislative references

Council Directive 2006/112/EC of 28 November 2006 on the Common System of Value Added Tax, art 14(2)(b)

Credit Contracts Act 1981 (repealed), s 3 ("credit contract")

Credit Contracts and Consumer Finance Act 2003, ss 5 ("cash price"), 6 ("credit"), 7 ("credit contract")

Goods and Services Tax Act 1985, ss 2(1) ("hire purchase agreement"), 3(1)(f), 9, 10(2), (5), (5A) ("cash price", "credit contract"), (5B) and (5C), 14(1)(a), 19E to 19Q, 24, 25(1)(aa) and (b), 60.

Hire Purchase Act 1971(repealed)

Income Tax Act 2007, s YA 1 ("hire purchase agreement")

Value Added Tax Act 1994 (UK), cl 1 of sch 4

Case references

Adaras Developments Ltd v Marcona Corp [1975] 1 NZLR 324 (HC)

Alexander v Tse [1988] 1 NZLR 318 (CA)

Aubit Industries Ltd (in rec and in liq) v Cable Price Corp Ltd (1994) 5 NZBLC 103,395 (CA)

Case C-164/16 HMRC v Mercedes-Benz Financial Services UK Ltd ECLI:EU:C:2017:734 (CJEU)

Collector of Customs v Chemark Services Pty Ltd (1993) 114 ALR 531 (FCA)

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Helby v Matthews [1895] AC 471 (HL)

Jane v Ben Hall Properties Ltd [1979] 2 NZLR 68 (CA)

Lee v Butler [1893] 2 QB 318 (CA)

Marac Finance Ltd v Virtue [1981] 1 NZLR 586 (CA)

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Murray v Scott [1976] 1 NZLR 643 (SC)

National Westminster Finance NZ Ltd v South Pacific Rent-a-Car Ltd [1985] 1 NZLR 646 (HC)

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Securitibank Ltd (No 2), Re [1978] 2 NZLR 136 (CA)

Woodroffe v Box (1954) 92 CLR 245 (HCA)

Other references

"GST and finance leases — classification, method of accounting and treatment of residual value clause", *Tax Information Bulletin* Vol 8, No 1 (July 1996): 1, www.taxtechnical.ird.govt.nz/tib/volume-08---1996/tib-vol8-no1

"IS 21/01: GST and agency", *Tax Information Bulletin* Vol 33, No 2 (March 2021): 21, www.taxtechnical.ird.govt.nz/interpretation-statements/2021/is-21-01

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