

## QUESTION WE'VE BEEN ASKED QB 14/06

### GST – HIRE FIRM SECURITY BONDS

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

This Question We've Been Asked (QWBA) is about ss 2, 8 and 10.

During a review of the *Public Information Bulletin* and *Tax Information Bulletin* series published before 1996, the answer to Question 11 in a series of GST questions and answers in *Public Information Bulletin* No 148, p 4 (May 1986) was identified as no longer reflecting the Commissioner's interpretation of the law as it relates to GST and hire firm security bonds. The Public Information Bulletin review has now been completed, see "Update on Public Information Bulletin review" *Tax Information Bulletin* Vol 25, No 10 (November 2013): 37.

This QWBA updates and replaces the *Public Information Bulletin* item.

#### Question

1. What are the GST implications of a customer paying a bond to a GST registered hirer of goods as security when the goods are hired?

#### Answer

2. The paying of the bond has no GST effect because there are no services supplied in return for the bond. If the bond is repaid in full on the return of the goods, that remains the case. If, or to the extent, the bond is forfeited because it is applied in accordance with the agreement between the parties:
  - as payment of an extra hire charge, because the goods are returned late, then it is consideration for a supply and is subject to GST;
  - as compensation for damage to, or loss of, the goods, then it is not consideration for a supply and is not subject to GST;
  - for the purchase of goods or services, then it is consideration for a supply and is subject to GST; or
  - for a breach of a condition (eg, operating the goods in a way not permitted under the hire agreement), it is not consideration for a supply and it is not subject to GST.

#### Explanation

##### *Background*

3. In *Public Information Bulletin* No 148, p4 (May 1986) there was a series of GST questions and answers. Question 11 asked: "What is the treatment of deposits by way of security (bonds) taken by hire firms, which are refunded when the goods are returned in good condition at the end of the hire period?" The answer provided was: "Such deposits are not consideration for a taxable supply and are not therefore subject to GST when paid. If, however, these deposits are appropriated as a result of a contingency such as non-compliance with the bond conditions, the amount so appropriated is consideration for a taxable supply and subject to GST."

4. Where a customer pays an amount as security for the return of goods (a bond) and the hire firm appropriates that amount as a result of a contingency, such as non-compliance with bond conditions, and does not supply anything in return to the customer, the Commissioner now considers there is no GST payable by the hire firm. In some scenarios this will result in a different answer to that provided in Question 11. This is because where there is no supply (as is the case in the second and last bullet points in [2] above) there is no GST.

#### *Taxable Supply*

5. For GST to apply to a transaction, a registered person must make a supply for consideration in the course or furtherance of a taxable activity they carry on. This is the combined effect of s 8(1), which imposes GST with reference to the "value of a supply", and s 10, which determines the value of a supply by reference to the "consideration" for the supply. "Consideration" is defined in s 2 to include:

any payment made or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods and services, whether by that person or by any other person; but does not include any payment made by any person as an unconditional gift to any non-profit body

6. For GST to apply to a payment, it must be more than just a payment to a registered person in the course or furtherance of their taxable activity. For GST to apply, the payment must also be a payment for a supply. To determine whether a payment satisfies this test, a relevant supply must be identified. Then it must be determined whether, or at what point, a payment is made for that identified supply (see *CIR v Databank Systems Ltd* (1989) 11 NZTC 6,093 (CA)).

#### *A bond*

7. When a customer hires goods from a hire firm, the customer may be asked to pay a bond. If the goods are returned on time and undamaged, the bond will be refunded. If the goods are returned late, the hire firm, in accordance with the agreement between the parties, may retain some, or all, of the bond to pay additional hire charges. A hire agreement may also provide that a bond will be forfeited, in whole or in part, for a breach of another term of the hire agreement. An example of such a term is a restriction on using the hired goods in a particular way or in a particular place or damaging or losing the goods. Other agreements may simply provide that customers must forfeit their bond if there is any damage to the hired goods. In these types of situations, working out whether GST applies to the bond payment requires identifying whether there is a relevant supply and then determining whether, or at what point, a payment is made for that identified supply. Each transaction must be carefully analysed to determine whether there has been a supply. This is demonstrated in the following scenarios, which identify some types of transactions that might arise in the hire industry.

#### *Initial payment of bond*

8. A hire firm may require a customer to pay a bond as security when the goods are hired. The initial payment of a bond is not for any supply. The payment arises in the context of a supply of hired goods but it is not for that supply. The bond is paid to give the hire firm an amount to resort to in case an event provided for in the agreement occurs. If the agreement is complied with, then the bond will be returned to the customer.

#### *Late return of goods*

9. Where, in accordance with the agreement between the parties, the hire firm retains some, or all, of a bond to pay additional hire charges because hired goods are returned late, that is consideration for a supply. For example, if goods are

hired for two days but returned after three, the amount of the bond forfeited is consideration for the extra day's hire of the goods.

10. In cases where previously agreed consideration is increased and a tax invoice has already been issued (and the supply is not a successive supply under s 9(3)), the supplier must provide the recipient with a debit note that meets the requirements of s 25(3)(b). If the supplier did not account for the increased amount of GST in the GST return in which the original supply was returned (as they were not then aware of that increase in consideration), the supplier must make the relevant adjustment in the GST return for the period in which it became apparent that the output tax they returned was incorrect.

*Damage to, or non-return of, hire goods*

11. Where, in accordance with the agreement between the parties, the hire firm retains some, or all, of a bond to compensate for damage to the hired goods, that is not consideration for a supply. The amount retained is a payment of damages. The Commissioner's view on the application of GST to damages is set out in "GST Treatment of Court Awards and Out of Court Settlements", *Tax Information Bulletin*, Vol 14, No 10 (October 2002): 21. GST will not apply where the payment is compensation or damages and not consideration for a supply.
12. The same reasoning applies where a bond is forfeited because the hired goods are not returned at all. The amount the hire firm retains is damages for the loss of the goods and is not consideration for any supply made by the hire firm to the customer.
13. However, if the hire firm and the customer agree that the customer will buy the goods, then GST will apply to that sale in the ordinary way with the hire firm issuing a tax invoice to the customer and returning the GST on that sale in the return for the appropriate GST period.

*Breach of another term*

14. A hire agreement may contain a term that restricts the use of the goods in a particular way or in a particular place and provides for the deposit to be forfeited if the term is not complied with. If the bond is forfeited for such a breach, GST will not apply. The hire firm does not supply anything for the amount forfeited. Generally, the amount will be an estimate of damage suffered because of the breach of the term. In some cases, forfeiture of the bond may be viewed as a penalty. That is relevant to the enforceability of the term but will not alter the GST treatment.
15. By contrast, the hire agreement may contain a term that does not restrict the use of the hired goods but instead provides that if the goods are used in a particular way extra charges will be incurred that will be forfeited from the bond. In this case, the hire firm is supplying something extra (ie, the use of the goods in a particular way) for the amount of the bond forfeited and, therefore, GST applies.
16. As stated above, for GST to apply, the payment must be a payment for a supply. Whether a payment is for a supply will ordinarily be determined by the terms agreed to by the parties. However, as is the case under any contract, where the true legal position does not accurately reflect the terms of the agreement (regardless of whether it is written or oral), it is the true legal position that determines whether there is a payment for a supply. In that regard nomenclature, by itself, does not determine the true legal position. Similarly, where the parties have not acted in accordance with the written terms of the hire agreement but have made an alternative agreement, it is that alternative agreement that is determinative (see *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA)).

*Different treatment for late payment charges and penalty and default interest payments*

17. It is important to note that late payment charges and payments of penalty and default interest are not the same as compensation or damages payments. There are specific sections that apply to late payment charges and payments of penalty and default interest. Under ss 5(25) and (26), a late payment charge on the payment of an account (not including a payment of penalty or default interest) will be liable for GST if the underlying supply to which that payment relates is subject to GST. Penalty or default interest imposed under a contract for the supply of goods or services is exempt from GST under s 14(3).

### **Examples**

18. The GST consequences of each of the Examples below are a result of those particular facts. This means that any additions, or variations, to the facts in the Examples may give rise to different GST consequences.
19. The hire firm in each Example is GST registered and all hire fees paid are GST inclusive.

#### **Example 1 – Goods returned late**

20. Robert rented a concrete mixer from ABC Hire for two days for \$50. Robert paid a bond of \$200. The hire agreement provided that the bond would be repaid to Robert if he returned the mixer on time and undamaged with the hire agreement providing that ABC Hire could charge an extra amount for any additional day(s) the mixer was retained beyond the agreed hire period.
21. Robert returned the mixer one day late. ABC Hire deducted \$25, for an extra day's hire, from the bond and returned the balance of \$175 to Robert.
22. The initial payment of the bond by Robert was not consideration for a supply, so ABC Hire does not have to account for GST on that payment. The \$25 deducted from the bond was consideration for the supply of the mixer for an extra day, so ABC Hire must account for GST on that \$25.

#### **Example 2 – Goods returned damaged**

23. Ann rented tables and chairs from ABC Hire for a party she was holding in her backyard. The total rent was \$300 and Ann also paid a bond of \$200 against the return of the furniture on time and undamaged. The hire agreement stated that the chairs must be returned in the same condition (fair wear and tear excepted).
24. Ann returned the furniture on time but two chairs were damaged. ABC Hire estimated that the cost of repairing the chairs would be \$60 and deducted that from the bond before returning the balance to Ann.
25. The initial payment of the bond by Ann was not consideration for a supply, so ABC Hire does not have to account for GST on that payment. The \$60 deducted from the bond was also not consideration for a supply. That deduction was to compensate ABC Hire for damage suffered, so it is not subject to GST.

#### **Example 3 – Goods not returned**

26. Helen rented a tent for a week from ABC Hire. Under the hire agreement, the rental charge for the tent was \$200, with Helen also paying a bond of \$300 to ensure the safe return of the tent.
27. When Helen did not return the tent, the manager at ABC Hire called the phone number Helen gave on the hire form. The person who answered the phone said

Helen used to live there but had left owing rent and without leaving a forwarding address. ABC Hire kept the bond as compensation for the loss of the tent.

28. The initial payment of the bond by Helen was not consideration for a supply, so ABC Hire does not have to account for GST on that payment. The forfeiting of the bond was also not consideration for a supply. The bond amount was taken by ABC Hire to compensate it for the loss it suffered (ie, the loss of the tent), so it is not subject to GST.

#### **Example 4 – Goods kept**

29. Brian rented a vintage suit from Suit Hire Co for his school ball. Under the hire agreement, Brian paid a bond of \$200 for the return of the suit on time and in the same condition (fair wear and tear excepted). Unfortunately, at the ball Brian ripped one arm of the suit.
30. When Brian returned the suit, he was told that he would forfeit the bond because of the damage. Brian asked Suit Hire Co what it would cost to buy the suit instead. Suit Hire Co told Brian if he paid an extra \$100 and forfeited the bond, the suit was his. Brian agreed.
31. In this case, Suit Hire Co relinquished its damages claim against Brian. Instead, Suit Hire Co sold the suit to Brian and applied the \$200 bond towards the \$300 purchase price of the suit. The initial payment of the bond by Brian was not consideration for a supply, so Suit Hire Co does not have to account for GST on that payment. However, Suit Hire Co must account for GST on the \$300 sale price of the suit, which includes the \$200 bond amount that was paid as part of the purchase price.

#### **Example 5 – Breach of a condition of hire**

32. Jane rented a car from Holiday Rentals for a day. Under the hire agreement, the rental charge was \$80 and Jane also paid a bond of \$200. The hire agreement also provided that the car was not to be driven on a local beach and that the bond would be forfeited if this condition was broken. Holiday Rentals included that term because cars driven on that beach regularly fell into holes. Sometimes the car suspension was damaged as a result and often cars had to be towed out. This condition was pointed out to Jane by the Holiday Rentals' manager when Jane signed the hire form.
33. The manager saw Jane driving the car on the beach later that day. When Jane returned the car, she was told that she had breached the hire agreement and Holiday Rentals would not be refunding the bond.
34. The initial payment of the bond by Jane was not consideration for a supply, so Holiday Rentals does not have to account for GST on that payment. The forfeiting of the bond is also not subject to GST. Under the hire agreement, Holiday Rentals did not supply anything to Jane in return for the forfeited bond, so it is not consideration for a supply.

## **References**

### **Related rulings/statements**

"GST Treatment of Court Awards and Out of Court Settlements" *Tax Information Bulletin*, Vol 14, No 10 (October 2002): 21

### **Subject references**

Consideration  
GST  
Hire bond  
Taxable supply

### **Legislative references**

Goods and Services Tax Act 1985, ss 2, 8 and 10

### **Case references**

*Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA)  
*CIR v Databank Systems Ltd* (1989) 11 NZTC 6,093 (CA)