

Hire purchase or lease? 3/43/22

A hire purchase is different from a lease in terms of various economic risks and VAT treatment. Although the customer is allowed to pay the purchase price by instalments, the supplier is liable to calculate and pay VAT on the entire amount of the transaction. This VAT treatment is not new, yet we have had to deal with situations where a taxable person has missed this important difference or finds it difficult to determine what kind of transaction is in fact taking place. This article explores key differences between the two transactions for VAT purposes.

A hire purchase

The VAT Act defines a hire purchase as a supply of goods in which a vendor delivers a particular asset that becomes the customer's property on an agreed date after he has made all the agreed payments.

A hire purchase is governed by the Civil Code (sections 2069–2071), reserving the seller's right to retain ownership of the asset until the purchase price is fully paid, or if the customer never pays it.

Thus, a hire purchase is a compound transaction having characteristics of a purchase, a lease, and a loan.

The VAT Act does not define a lease. A lease is taken to mean an agreement under which one party grants or promises the use of an asset to the other party for a certain rental (sections 2112–2177 of the Civil Code). Section 2130 states that the lessor must deliver the asset to the lessee. The lessee is treated as the actual possessor of the asset, not the legal possessor.

Treating a transaction as a hire purchase

The legal form of a contract is not decisive in assessing whether it's a hire purchase or a lease. For tax purposes, we need to examine the actual intention of the parties and the economic reality. On the face of it, a hire purchase might look just like a lease – especially if the option to buy the asset at the end of the lease is only formal. During tax controls, the State Revenue Service may find that the true intention of the parties was to make a supply of goods, which is merely documented to look like two separate transactions: a lease and a purchase.

Every now and then disputes over whether a particular transaction is a hire purchase or a lease end up in the courts, including the Court of Justice of the European Union (CJEU).¹ The CJEU's rulings and the Advocate General's opinions allow us to analyse the differences between the two transactions.

According to the CJEU, a legal relationship the parties have set up as a supply of services should not be treated as a supply of goods. In particular, a transaction that has the following characteristics would be considered a lease service:

- The recipient of the asset must in principle return it to its owner once the lease expires.
- The payment to be made in exercising the right of purchase prescribed by the lease agreement matches the average estimated value of the asset or represents a substantial part of its full price at the time of purchase. The decision to buy the asset depends not only on its price but on whether the company needs it and whether it's suitable for the company's future business.

A hire purchase, on the other hand, typically involves the following criteria:

- Passing ownership of the asset to the customer at the end of the agreement is an essential element of the agreement. The transfer of ownership occurs free of charge after all the payments have been made, or for a token purchase price when the customer unilaterally expresses the desire to buy the asset. The transfer of ownership is certain or very likely, it has been merely postponed, yet it takes place as a result of ordinary performance of the agreement. In certain cases a lease may be reclassified as a hire purchase even if it does not provide for a transfer of ownership to the lessee but it covers the entire useful life of the asset.
- The agreement transfers most of the rewards and risks associated with lawful ownership to the customer.
- The amount of rental payments is practically identical to the market value of the asset (the rental covers the purchase, depreciation and financing costs incurred by the seller).

VAT treatment of hire purchases and leases

As stated above, it's crucial that we distinguish a hire purchase from a lease because these transactions are treated differently for VAT purposes. A supply of goods is treated as made when the goods have actually been supplied but no later than when the customer has received them. A supply of services has taken place when the services have been supplied to the customer.

A hire purchase cannot be treated as a supply of goods over a long period for which regular invoices are issued. So, as soon as the asset is delivered to the customer, VAT on the entire contract amount must be calculated and paid to the tax authority, although the consideration for the supply will be received in future periods.

Remember that terminating a hire purchase of real estate may have additional tax implications as well. If the agreement is terminated and the asset remains the supplier's property, the transaction is treated as a lease service from the first payment up to the termination. This provision does not apply to hire purchases of residential space that is not used in business.

¹CJEU ruling C-164/16 of 4 October 2017 and the Advocate General's opinion, CJEU ruling C-118/11 of 16 February 2012, and CJEU ruling C-209/14 of 2 July 2015