



LRA VALUE ADDED TAX PUBLIC RULING

Value Added Taxation on Finance Lease/ Hire
Purchase

[Policy, Procedures and Law Interpretation]

12/18/2013

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1.0 Key Definitions

The definitions of words as used in the Financial Regulations 2013¹, Hire Purchase Act 1974² and VAT Act of 2001³ shall have the same meaning within the context of this Public Ruling ad, unless otherwise stated or required by necessary implication, the following definitions, abbreviations and interpretations shall mean:

- i. “Asset” means all property that is non-consumable and includes personal property, goods and equipment that can be legally sold or imported into Lesotho, that becomes the subject matter of a finance lease agreement, whether or not the asset has become a fixture to or incorporated in land, and includes immovable property, natural resources, trade-marks and copy rights or other moral rights to intellectual property and computer software but does not include shares, investments, securities, any financial instrument, government bonds and securities, or any other moveable property whose free circulation in the country is restricted by law;
- ii. “the LRA” LRA means the Lesotho Revenue LRA.
- iii. “consideration” in relation to a supply or import means the total amount in money or kind paid or payable for the supply or import by any person, directly or indirectly, including any duties, levies, fees or charges paid or payable on, or by reason of, the supply or import other than value added tax, reduced by any price discounts, rebates allowed and accounted for at the time of the supply or import;

¹ Regulations No. 39 of 2013

² Act No. 27 of 1974

³ Act No. 9 of 2001

- iv. “finance lease”, in relation to goods, means the lease of the goods where –
- (a) the lease term exceeds 75 % of the effective life of the goods for income tax purposes;
 - (b) the lessee has an option to purchase the goods for a fixed or determinable price at the expiration of the lease term; or
 - (c) the estimated residual value of the goods to the lessor at the expiration of the lease term (including the period of any option to renew) is less than 20% of its market value at the commencement of the lease;
- v. “Hire Purchase agreement” means any agreement whereby goods are sold subject to the condition that the ownership in such goods shall not pass merely by the transfer of the possession of such goods, and the purchase price is to be paid in instalments, two or more of which are payable after such transfer, and includes any other agreement which has or agreements which together have the same import, whatever form such agreement or agreements may take: Provided that any agreement which or agreements which together provided for letting and hiring of goods-
- (a) with the right to purchase such goods only after two or after more than two instalments subsequent to such transfer have been paid in respect thereof; or
 - (b) with the right, after two or after more than two instalments subsequent to such transfer have been paid in respect thereof, to continue or renew from time to time such letting and hiring at a nominal rental, or to continue or renew from time to time the right to be in possession of the goods, without any further payment or against payment of the nominal periodical or other amount,

(c) shall whether or not the agreement or agreements may at any time be terminated by either party or one of the parties, for the purpose of this Act, be deemed to be of the said import.

- vi. “lessee” means a person who enters into a financial lease with the lessor and includes its successor, assignee and sub-lessee;
- vii. “lessor” means a person who enters into a financial lease with a lessee, and whose company is licensed under regulation 31 to provide a service of financial leasing;
- viii. “person” includes a legal, private or public entity;
- ix. “Regulations” means The Financial Lease Regulations of 2013;
- x. “the VAT Act” means the Value Added Tax Act No.9 of 2001, as amended;
- xi. “VAT” means value added tax as imposed in the VAT Act;
- xii. “vendor” means a person who is, or is treated as, registered under the VAT Act.

2.0 Background

The VAT administration has experienced a number of hurdles in relation to the taxation of transactions concerning finance leasing and, in some respects, those of Hire Purchase. This factor on its own has thus resulted in uncertainties in respect of the appropriate taxation of these transactions and thus a huge confusion to the taxpayers concerning their obligations as provided in the VAT Act. Consequently, the VAT treatment of transactions relating to finance leasing and Hire Purchase agreements has remained a debatable subject amongst both the VAT administrators and vendors alike. This has led to differences in the application of the law by vendors, hence inconsistencies in declarations made to

the LRA. This Public Ruling therefore seeks to provide clarity and guidance in taxation of finance lease and hire purchase transactions. The Public Ruling considers the relevant provisions of the laws governing finance lease and hire Purchase transactions been the Finance Institutions Act 2012 particularly Section 27(1) thereof, the Regulations, the Hire Purchase Act 1974 and the VAT 2001 .

3.0 Purpose

The objective of the Public Ruling is to provide the LRA's interpretation of the application of the provisions of the VAT Act 2001 in finance lease and hire purchase transactions, particularly the sections 3, 4, 9(3), 14(2) (a). The Public Ruling also considers the provisions of the Financial Institutions Act 2012 and Regulations and the Hire Purchase Act 1974 for the determination of the form and substance of the finance lease and Hire Purchase agreements, respectively.

4.0 The Law and its Application

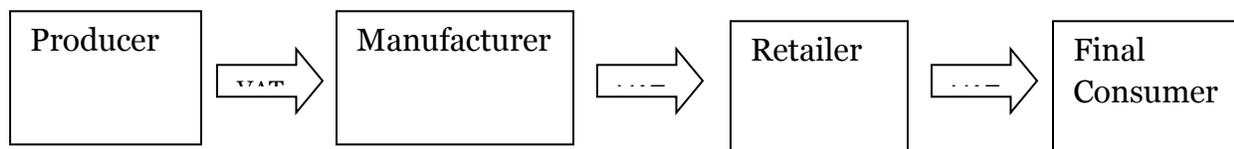
4.1.1 The VAT 2001

4.1.1.1 Requirements for VAT

The important consideration for VAT purposes is whether there is supply, and in the case that there is, whether it is a taxable supply. The VAT is levied on the taxable supply. The VAT Act defines a supply of goods in general terms as any arrangement in which the owner of goods parts with or will part with possession of such goods and it includes an agreement of sale or purchase, with the exclusion of consignments or transfer of possession in a representative capacity. The supply of services, on the other hand, refers to any activity carried out that is not a supply of goods and money, including a supply by electronic means, a transfer

or assignment of copy rights, patent, license, trademark or similar rights. Once it is established that there is a supply, the next step would be to determine whether the supply is taxable or exempt. This therefore means that an action should first qualify to be a supply before the decision can be made on its taxability status.

After the supply has been classified under taxable supplies, it is put through a test on some generic characteristics of VAT as a tax system. One of these features prescribes that VAT be levied at every stage of a supply chain as shown in the diagram below:



Thus, VAT is charged on the mark-up throughout the distribution chain.

For the taxation of finance leasing or hire purchasing, the critical enquiry would first be to establish whether there has been finance leasing of goods within the meaning of definition as provided above and whether there has been a Hire Purchase arrangement of goods within the meaning of the Hire Purchase Act 1974⁴. Secondly, the question would be whether there has been a supply in transactions of hire purchasing or finance leasing.

Section 9(3) of the VAT Act provides that the supply of goods under a hire purchase agreement or finance lease occurs on the date of commencement of the hire or lease⁵. Further, having established that there is a supply of hire or lease,

⁴ Section 3 of the VAT Act provides that hire purchase agreement means an agreement that is a hire purchase for the purposes of the Hire- Purchase Act 1974

⁵ It must be noted where one has entered into a finance leasing or hire purchase arrangement in respect of services, the normal rules of taxation of services shall apply.

the VAT will be applied on the taxable value of the taxable supply of the hire or lease.

4.1.2 Financial Regulations

In terms of Regulation 5 (a) of the Regulations, a financial leasing transaction must have at least three parties involved, that is, the lessor, the lessee and the supplier.

The lessee will approach the lessor to seek finance of the asset of choice identified from the supplier i.e. the seller. Out of this arrangement, the lessor and the lessee will thereafter enter into a contract wherein the lessor will finance the lessee for the purchase of the asset. On the other hand, the lessor shall enter into a supply contract with the seller of the goods as identified by the lessee. The most significant factor that must be specifically noted is that, in terms of the financial leasing agreement as entered into between the lessor and lessee, the ownership of the goods rests with the lessor. This is nonetheless, a flexible contract upon which, the lessor and the lessee can further agree to specific terms such as the extension of the lease period.

However, although the lessee has no ownership rights during the period of the lease, the lessee in terms of Regulation 5(e) has an option to purchase the goods at the residual value. Nonetheless, during the period of the lease, the lessee is obligated to, amongst others, receive the goods directly from the supplier, make periodic rental payments to the lessor over a specified term and use and take proper care of the goods.

4.1.3 Hire Purchase Act 1974

In the same manner as in the case of finance leasing, there are specific characteristics that must be seen in a hire purchasing arrangement for such an arrangement to be considered a hire purchase arrangement within the meaning of the Hire Purchase Act. Thus, it must be recalled that, the hire purchase agreement is recognised as such by the VAT Act only if it is the hire purchase agreement for the purposes of the Hire Purchase Act.⁶ Accordingly, in terms of the Hire Purchase Act, for the agreement to be considered as a hire purchase agreement, it should meet at least the following conditions;

- 1) There should be a buyer and a seller;
- 2) Transfer of goods from the seller to the buyer should take place immediately after the agreement has been entered into;
- 3) The purchase price must be paid in 2 or more instalments;
- 4) Ownership of goods should be passed on to the seller after the payment of the final instalment.

It means therefore that, unlike in a finance leasing arrangement, there are only two parties involved in a hire purchase arrangement. They are the seller and the buyer who shall, in the similar fashion as in the financial leasing arrangement, defer the ownership of goods involved on delivery until the final payment is made. It is clear that though the hire purchase arrangement is closely similar to the finance leasing arrangement, the difference is that under the hire purchase arrangement there is no option to buy the goods involved as ownership shall then at the end of the hire agreement transfer to the buyer.

The other important difference for hire purchase arrangements is that, unlike in the case of financial leasing arrangements, the hire purchase contracts are

⁶ See section 3 of the VAT Act on the definition of "hire purchase agreement".

inflexible in the sense that there is no freedom for the buyer and seller to re-negotiate terms once the agreement is concluded.

4.2.0 The Taxable Value

As is the case with other taxable supplies, the supply by lease or hire is taxable on the value attached to the goods being supplied. This taxable value is the fair market value of the goods at the time of supply. The fair market value in this case is the consideration in money which similar goods would generally fetch if supplied or imported under a lease or hire agreement on the same date, when offered freely between persons who are not associates⁷.

From the definition of consideration in the definition section above, it has been indicated that any duties, levies, fees or charges due on the supply of a good should be included in the value on which VAT is charged. The fees or charges referred to in the composition of the value making the consideration as shown above, include all the other charges of services incidental to the good being supplied or imported. In other words, the value on which VAT is levied is the value normally capitalized to the cost of an asset, for instance the purchase price, import duties, transportation, installation costs, and any other costs that can be directly linked to bringing the good to the location and costs related to condition(s) necessary for its intended use.

Ideally, although it is apparent that the consideration for VAT purposes includes a number related costs as referred to in the previous paragraph, it must be noted that there are costs that are specifically excluded from consideration. These

⁷ Persons are said to be associates if the person is likely to act in accordance with the directions, requests, suggestions, or wishes of the other person.

include those costs attributable the provision of credit i.e. interest, finance charges or any other charges determined with reference to the time value of money.

4.3.0 The Time of Supply

The supply under the finance lease or hire purchase is considered to take place on the commencement of the lease or hire as stipulated in the contract. Put simply, the time of supply is on the effective date of the lease or the hire. This therefore means that the VAT liability will arise as soon as the parties have contractual obligations in respect of the lease or hire. Consequently, there is no VAT liability for the lessor or seller at the time the instalments are received during the term of the agreement.

4.3.1 Example 1

Furniture Galore, a vendor, has sold a 72 cm plasma television, a queen size bed and oak television stand to Mrs 'Malitaba Litaba for M9, 499.99 and M4, 799.99 respectively. The goods were sold under a hire purchase agreement which was entered into on the 8 June 2013. The total amount due is M32, 217.84⁸ and is payable in 24 instalments of M1, 342.41 per month. 'Malitaba made a M2, 000.000 deposit on the purchase and traded in her old television for M400.00. The breakdown of the total amount due as per the contract agreement is as follows:

72 cm Plasma TV	M9, 499.99
Oak TV stand	M4, 799.99
Queen size bed	M5, 599.99

⁸the amount due excludes M2, 000.00 deposit and M400.00 trade in

Goods Total	M19, 899.97
Handling charges	M800.00
Transport	M350.00
Maintenance	M1, 193.99
Stain prevention spray	M469.99
Customer protection Insurance	M3, 605.99 ^{*9}
Deposit	M2, 000.00
Trade in	M400.00
Revenue stamp	M16.00*
Finance charges ¹⁰ @ 22%	M5, 881.90*
Total Purchase Price	M34, 617.84 <i>inclusive of VAT.</i>

Question 1

How much output VAT is payable to the LRA on the transaction and when is it payable?

Answer

$$\begin{aligned}
 \text{Taxable value} &= \text{Total purchase price} - \text{Total of values with asterisk} \\
 &= \text{M}34, 617.84 - \text{M}9, 503.89 \\
 &= \text{M}25, 113.95
 \end{aligned}$$

⁹ The amounts in asterisk are exempt as per section 6 of the VAT Act

¹⁰ Finance charges are charged on the amount excluding deposit and trade in.

$$= M25, 113.95 * 14/114$$

VAT Due = **M3, 084.16** (It is payable on the 8 June 2013 and it should be declared in the VAT return of June 2013.)

4.3.2 Example 2

Mr Maichu Melato has bought a brand new sedan from a vendor, Maseru Drive (Pty) Ltd. The cash price of the motor vehicle was M563, 688.73 inclusive of VAT. The motor vehicle was financed by Thusong Bank, a local bank. Mr Melato made a deposit of M300, 000.00. The terms of the agreement included payment of the loan in 60 monthly instalments of M6, 885.78. The total amount charged by the bank included M5, 250.00 in administration fees and M61, 577.20 in finance charges.

Question 2

Who is responsible for accounting and paying the output VAT to the LRA in this transaction?

Answer

Maseru Drive (PTY) Ltd a vendor is responsible for the output tax collected on the transaction. It must be noted that, there is no output VAT payable by Thusong Bank for the reasons that the transaction or arrangement between the Thusong Bank and Mr. Maichu Melato does not qualify as either a hire purchase or a finance lease. The situation here is that Mr Maichu Melato has a financial arrangement with the Thusong Bank to be provided with a loan to acquire a motor vehicle. The act of financing goods by a loan agreement is a classic example of traditional financing which does not fall within the meaning of the hire purchase or financial lease as legislated. It must be noted that the charges in respect of this transactions, such as administration fees and finance charges are

financial services provided towards granting, negotiating and dealing with a loan and are therefore exempt from VAT.¹¹

4.3.3 Example 3

Mahala Heavy Duty acquired construction equipment from We Build the Nation for M600, 000.00, including M5, 000.00 for transportation. Mahala Heavy Duty, a vendor, leased back the equipment to We Build the Nation on which it is to receive monthly rentals of M11, 000.00 payable on the first day of every month. Included in the monthly payment are portions of M3, 000.00 administration charges and M5, 000.00 setup costs.

Question 3

What are the VAT implications?

Answer

VAT due on the sale of the equipment by We build the Nation is:

$$600,000.00 * 14/114$$

$$= \mathbf{M73,684.21}$$

When the equipment is leased back, Mahala Heavy Duty becomes the lessor and the VAT payable on the leasing transaction is:

$$600,000.00 + 3,000.00 + 5,000.00 * 14/114$$

$$= \mathbf{M74,666.67}$$

¹¹ Section 6 of VAT Act 2001 as amended

This is due at the commencement of the lease back. Thus, there will be no VAT payment on the rentals that are paid on a monthly basis.

4.4.0 Implication of a Bad Debt

In terms of the Section 26 (1) of the VAT Act, a vendor is allowed a credit for the value added tax paid in respect of a taxable supply made by the vendor where either the whole or part of the consideration for a supply is subsequently treated as a bad debt. This means therefore that, a vendor who has supplied by way of finance leasing or hire purchase is equally entitled to a credit where part or the whole consideration was not recovered from the recipient of the supply, provided that the vendor had already accounted for the supply in a VAT return.

The adjustment is calculated on a pro-rata basis by taking into consideration the amount already received by the vendor against the lease price and the amount actually written off. However, the VAT Act requires that in order for the input tax credit to be claimed in this manner, that the bad debt should have been removed from the book of accounts as a bad debt or should have been declared as a bad debt at the end of a period of 12 months after the tax period on which VAT was paid on the supply¹².

4.4.1 Example 4

Litsietsi Excavators acquired a TLB from Heavy Duty (Pty) Ltd on finance lease through Boipheliso Leasing (Pty) Ltd, a registered finance leasing company, for M502, 000.00, including VAT and transportation charges. Litsietsi Excavators Managing Director signed a lease contract with Boipheliso Leasing (Pty) Ltd in July 2010, which contract provided that Litsietsi would repay the equipment at M11, 000.00 monthly instalments for 60 months. Two years down the line,

¹² Section 26 of the VAT of 2001 as amended

Litsietsi Excavators was liquidated and Boipheliso Leasing (Pty) Ltd could neither repossess nor get any money from the liquidators as priority creditors' claims did not leave any money available to the other creditors. Boipheliso Leasing (Pty) Ltd had both observed their return filing and payment at the relevant tax periods.

Question 4

How much input tax credit can Boipheliso Leasing (Pty) Ltd claim in its July 2013 return.

Answer

Boipheliso Leasing (Pty) Ltd can claim credit for input tax in the tax period June 2013 using the following formula:

$$(C - D) * (E - F) / C$$

Where C = Total amount of money expected to be paid by the end of the agreement term.

D = Total amount in money paid as at the time of the last instalment.

E = Total VAT accounted for by Boipheliso Leasing (Pty) Ltd

F = VAT attributable to part payment if any.

$$C = M11,000.00 * 66 \text{ months} = M660,000.00$$

$$D = M11,000.00 * 24 \text{ months} = M264,000.00$$

$$E = M502,000.00 * 14/114 = M61,649.12$$

$$F = M0.00$$

$$\text{VAT claimable} = (C - D) * (E - F) / C$$

$$\begin{aligned}
&= (660,000.00 - 264,000.00) * (61,649.12 - 0) / 660,000.00 \\
&= 396,000 * 0.093 \\
&= \underline{\underline{\mathbf{M36,989.47}}}
\end{aligned}$$

NB: As Boipheliso Leasing (Pty) Ltd had paid the full amount of VAT to the LRALRA at the beginning of the lease, this amount becomes an allowable credit as it is the amount of VAT that Boipheliso Leasing (Pty) Ltd has not gotten from Litsietsi when it stopped making payments.

4.5.0 Implication on Repossession

Where the seller repossesses goods before the lease or hire purchase agreement ends and subsequently sells those goods, the sale is a taxable supply on which the seller must account for VAT. The VAT due is calculated using the special rules of second hand goods. The taxable value for the purposes of used goods is the difference between the sales price and the purchase price. In the case where the purchase price is greater than the sales price, then no VAT is payable. It is worth noting that if the goods are repossessed from a registered vendor, the transaction becomes a deemed supply by the debtor and the debtor should account for output VAT only if VAT was claimed when the goods were purchased.

4.5.1 Example 5

Assuming the same facts as in the case in a bad debt example above, with the only difference being that the goods were repossessed and sold for M200,000.00.

Question 5

What are the tax implications?

Answer

The TLB was initially bought for M502, 000.00 and it is now sold at a lesser price of M200, 000.00 and therefore no VAT is payable. However, if the reselling price was for instance M750, 000.00, then the taxable value would have been M258, 000.00 and the value added tax would be charged on this price. On the latter, the seller would be expected to account for M34, 720.00 as value added on the resale of the repossessed good(s).

5.0 VAT treatment from other Countries

Some countries differentiate between credit sales in which a finance company is involved into a sale under a hire purchase and a sale financed by a loan agreement which is a typical traditional financing. In respect of these countries, the sale under a hire purchase agreement is the sale in which the finance company becomes the owner of the goods while the one financed by a loan agreement is the sale in which the finance company does not become the owner of the goods. Under a hire purchase, a supply is made to the finance house while under a loan agreement the supply is made to the customer. Sale of goods under a hire or lease is recognised as a taxable supply with the difference being the application of the time of supply rule, hence the taxable value. In some countries which are still under the General Sales Tax (GST) regime, tax is payable on the monthly instalment and it becomes due on the earlier of the payment due date or the time payment is actually received. The countries reviewed were the United Kingdom and Australia. Some countries do not have special rules relating to lease financing or hire purchasing. Kenya is an example where transactions relating to

lease or hire are are taxable with VAT due on the earlier of invoicing, payment and delivery of goods.

On the other hand, most countries with VAT systems similar to Lesotho's have a consistent treatment of the VAT taxation of the finance leasing and hire purchase transactions as Lesotho. For instance, Mauritius deems a supply under a hire or lease as a taxable supply with time of supply under the former as the time the agreement is entered into while with the latter as the earlier of invoicing and payment. Similarly, the Republic of South Africa has similar application to Lesotho in that transactions relating to finance lease and the instalment credit agreement like hire purchase agreements are treated in the same manner under the VAT system. Full VAT is due on the purchase price at the commencement of the finance lease or instalment credit agreement.

6.0 Conclusion

The first requirement is to determine whether a transaction is that of a hire purchase or a finance lease. Having done so, secondly, it becomes equally important to note the time of supply, that is, the time on which VAT becomes payable and the taxable value, which is the value on which VAT is levied. VAT is due at the commencement of the finance lease or hire purchase and it is levied on the fair market value of the goods at the time of the hire or lease. It is also essential to differentiate between a finance lease or hire purchase and the traditional rules of financing when applying the VAT Act on a transaction.

Disclaimer

This Public Ruling provides the general interpretation of the law and considers broad principles in guiding the administration of VAT on taxable supplies by way of finance lease or hire purchase. The Public Ruling has no binding legal force and does not affect a taxpayer's right of objection and appeal to the Commissioner General, the Revenue Tribunal or the Courts of Law. This Ruling shall not affect the taxpayer's right to argue for a different interpretation, where necessary, in any appeal process, as stipulated in the revenue laws. Neither is this Ruling binding on the Commissioner General, should circumstances arise for deviation as necessary or as the Commissioner General may deem otherwise in his discretion.