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GST and property – part III

Property developers

INTRODUCTION

This paper is the final in a three part series. In March I considered various GST issues that affect landlords and tenants and in April I looked at issues that confront vendors and purchasers. In this paper I will conclude the series by reviewing several issues that confront property developers.

IN THE COURSE OR FURTHERANCE OF AN ENTERPRISE

In April I reminded readers that a supply of real property will only be taxable when it is made in the course or furtherance of an enterprise and that the definition of enterprise in s. 9-20 is broader than the income tax rules as to when a taxpayer is conducting a business. Whether or not a taxpayer is conducting an enterprise is a question of fact and the term enterprise is defined in the GST Act to include either a single activity or a series of activities conducted, inter alia, in the form of a business or an adventure or concern in the nature of trade[1].

The term business is also widely defined and has broadly the same meaning as that provided for income tax purposes[2] therefore we can look to the line of income tax decisions that distinguish between a business and hobby to assist us determine the scope of the term business as it is used in s. 9-20. Certain indicia of the existence of a business have been developed in the context of GST law in overseas jurisdictions. If Australia follows this jurisprudence then provided an economic activity is carried out that would usually be sufficient evidence that an enterprise is being carried on[3]. Other tests include:

- whether the activity was 'any occupation or function actively pursued with a reasonable and recognisable continuity', or;
- are the activities of a kind commonly carried out by those who seek to profit by them[4].

This means that if there is a reasonable expectation of profit from the activity a person whose occupation has nothing to do with property development can still be subject to GST on a transaction that involves purchasing a corner block, subdividing the land, keeping the front house as your family home and spec building a town house on the rear of the site[5].

Example

Deniz is a retired airline pilot. She decides to subdivide her family home, build two town houses and sell these to pay the ingoing costs at a retirement home. Deniz engages a surveyor to attend to all the formalities in regard to subdividing the land, a builder to undertake the development and a real estate agent to sell the properties.

While we can assume that Deniz does not intend to establish a property development business she may be conducting an enterprise in the form of an adventure or concern in the nature of trade. The alternative argument is that Deniz is merely realizing the value of the land in the most favourable way. Whether or not this is the case will depend on matters of fact and degree. The courts have considered whether or not a transaction constitutes a mere realization of the land (which would be subject to capital gains tax) or amounts to profit or income from a business undertaking (which is taxed according to ordinary concepts) on several occasions. The leading cases are *Statham v FCT* (1998) 20ATR228; *Casimity v FCT* (1997) 37ATR358; and *McCorkell v FCT* (1998) 39ATR1112.

In my view, we can re-interpret this income tax law into the GST area with a reasonable degree of confidence. The above cases indicate that the following tests will give some guidance as to whether or not Deniz is conducting an enterprise:

- *The purpose for which she originally acquiring the land.* Deniz acquired the land for use as her family home, which indicates that the transaction is of a personal nature. This would mean that a disposal would not amount to the conduct of an enterprise. However, if at the time Deniz acquired the premises she had in mind to sub-divide the land in the future, then the subsequent subdivision will probably amount to an enterprise in the form of an adventure or concern in the nature of trade.

- *The magnitude of the development.* The Courts have said that if the cost of sub-division exceeds the market value of the land itself, this suggests a business of land development is being carried on, rather than merely realizing the asset for its best possible price.

- *The reason for subdividing the land.* I think the Commissioner correctly makes the point in para 46 of GSTR 2001/7 that where an entity acquires a single asset for resale at a profit, the activity will amount to an enterprise. However, subdividing a family home to finance a move into a retirement home or repay debts (for example) would indicate a different intention. These examples would support an argument that the transaction is a mere realization of the asset.

- *Whether or not Deniz unsuccessfully attempted to sell the land before sub-dividing it.* If so, this indicates that Deniz was prepared to sell the land without sub-dividing it and that any subdivision that follows merely amounts to putting the land in a condition where it can be sold, not the conduct of an enterprise.

- *Whether or not Deniz has sub-divided other properties in the past.* If she has, there is some continuity in her activities and this would suggest that this subdivision amounts to a business venture.

Other factors that would suggest that Deniz has an intention of carrying on an enterprise would be whether or not she will borrow to finance the development; undertake any works herself; be directly involved in any proposal to sub-divide the land; or has an established business organisation to prepare the land for sale.

McCorkell's Case suggests that an owner of land who merely holds it until the price of land has risen and then sub-divides and sells it is not engaged in carrying on a business despite the fact that the landowner:

- sought and acted upon the advice of an expert as to the best method of sub-division and sale,

- sub-contracted out works such grading, leveling and road building works and the provision of sewage, water and power.

However, in my view the scope of the works undertaken by McCorkell would probably amount to an enterprise in the form of an adventure or concern in the nature of trade. In contrast, Deniz did not undertake any of the works herself she merely contracted with three professionals to undertake all the works necessary to build the two units.

PROPERTY OWNING PARTNERSHIPS AND TURNOVER THRESHOLD

Example

Two discretionary trusts jointly own commercial premises and receive rent of $60,000 which they split 50/50 in their individual tax returns. The trusts have now sold the land and now seek advice as to whether this transaction will be a taxable supply. The trusts are not registered for GST and do not lodge a partnership tax return.

As the two discretionary trusts are co-owners of an income-producing property from which they jointly receive income they are deemed, for the purposes of the income tax law, to be in partnership. For income tax purposes, a partnership is not a separate legal entity distinct from the partners forming the partnership and has no direct liability for payment of income tax. However, contrary to the position under income tax law, Div 184 provides that a partnership (as that term is defined in s 995-1 of the ITAA 97) is a separate enterprise for GST purposes.

As the partnership is conducting an enterprise in the form of granting a lease over an interest in property if its annual turnover meets the registration threshold then the partnership is required to be registered for GST.

Section 188-25 of the GST Act excludes from the measurement of projected annual turnover a supply of a capital asset and a supply made solely as a consequence of a ceasing to carry on an enterprise or substantially and permanently reducing the size or scale of an enterprise. The effect of this section is to exclude unusual large one off supplies that would cause a person to cross the turnover threshold even though the ordinary turnover would fall below the threshold.

There term capital asset is not defined in the legislation and so acquires its ordinary usage, meaning an asset associated with the underlying business structure of an enterprise (such as land and buildings) as opposed to assets used in the course of the enterprise's business (such as inventory)[6]. The sale of commercial premises by a landlord would amount to the sale of a capital asset. This means the consideration received by each of the trusts for the supply of the land and buildings should not be taken into account when calculating each trust's turnover for the purposes of the registration turnover threshold.[7]

However, on the facts in this example, the partnership's rental income alone is in excess of $50,000 therefore it is required to be registered for GST consequently the sale of the land and buildings will be a taxable supply.

One off development

A taxpayer, who is otherwise not registered for GST who undertakes a one off property development will be required to register and pay GST on the proceeds of the sale of the development. The Commissioner explains the position in paras 47 of GSTR 2001/7 as follows:

> "The disposal of that single asset, or the completion of that isolated transaction, is not a transfer solely as a consequence of ceasing to carry on an enterprise. In such circumstances the enterprise ceases as a consequence of the disposal of the single asset, rather than the single asset being disposed of in consequence of ceasing to carry on the enterprise."

NEW RESIDENTIAL PREMISES AND OWNER BUILDERS

The ATO's position in regard to new residential premises is still unclear. Draft GST ruling GSTR 2001/D3 deals with this issue however this ruling has been strongly criticized by the tax profession. According to GSTR 2001/D3 residential premises will be new residential premises in these three circumstances:

- the premises have not previously been sold as residential premises;

- the premises have been created through substantial renovations of a building;

- a building is demolished and residential premises are built in its place.

There are four main exceptions to the general rule:

- The sale does not meet all the threshold tests in section 9-5.
- The premises have been used to generate input taxed supplies for a period of at least five years (s. 40-75(2)).
- The premises were used for residential accommodation before 2 December 1998 (s. 40-65(2)(b));
- The new residential premises are sold as a going concern (Subdiv 38-J). However; reliance on this exception will usually result in the purchaser incurring an increasing adjustment in accordance with Div 135.

For a detailed analysis of the problems with this draft ruling please refer to the joint paper prepared by the Institute and the accounting bodies that is available from the Institute's website.

It has become a relatively common practice of some small builders to construct a new house, live in it for a while and then sell it and claim there is no tax payable on the profit because it is merely an exempt capital gain under the main residence exemption[8]. Whether or not this strategy is effective from an income tax point of view is not necessarily determinative from a GST point of view because of the wide meaning of the term enterprise and the scope of the anti avoidance provisions in Div 165. However, if the builder is truly only selling their private residential premises then the sale should not be in the course of furtherance of an enterprise and therefore will not be subject to GST.

Further, if the construction of the premises was in the course of the builder's enterprise the mere fact that the builder has used the premises as his family home for five years will not bring the home within the s. 40-75(2) exemption as self-use does not amount to making an input taxed supply.

Section 11.2.4 of the Property and Construction Industry Partnership issues register deals with builders who build their own home and later on-sell the property. Practitioners should refer to this source whenever advising clients who are in this position. This said, there are two obvious litmus tests:

- the frequency with which a builder undertakes these transactions;
- the length of time the builder lives in each house before selling.

DEVELOPER CONTRIBUTIONS

Completion of most large property development requires the developer to make monetary and/or non-monetary contributions to the local council as part of the planning approval process. The monetary contribution is meant to compensate the council for the costs it will incur in up-keeping new infrastructure assets such as roads, footpaths and parks. Actually transferring title to this land is a non-monetary contribution.

The grant of the right to develop the land, by the council, and transferring the land to the council are both non-monetary supplies for GST purposes. In the ordinary course of events these supplies would be taxable and the value attributable to the supplies would be the market value of each supply[9]. However, a new Div 82 has recently been proposed for insertion into the GST Act. While this amendment is still before Parliament it will have retrospective effect back to 1 July 2000. The Bill provides that:

- a supply, by an Australian government agency, of a right to develop land is not treated as consideration for the supply of an in-kind developer contribution[10].
- the supply of an in kind developer contribution will not be a taxable supply[11]; and

GST TREATMENT OF DISPLAY HOMES

Under subs 40-35(1) a supply of premises by way of lease is input taxed if it is a supply of residential premises. A house is ordinarily a residential premise as it is intended to be occupied, and is capable of being occupied, as a residence[12]. However, s. 40-35(2)(a) provides that the supply is input taxed only to the extent that the premises are to be used predominantly for residential accommodation.

The ATO say that it is the use or proposed use intended by the supplier that mark the house out as residential premises and the use or intended use by the occupier that mark the house out as residential accommodation. Therefore, in order to determine whether the supply of a display home is input taxed, the ATO consider that the main issue that needs to be considered is whether the test in s 40-35(2)(a) is met.

In para 20 of GSTR 2000/20 The ATO says:

> To be used for 'residential accommodation' or to be 'occupied as a residence', premises do not have to be a home or a permanent place of abode. To be residential premises as defined, a place need only provide sleeping accommodation and the basic facilities for daily living, even if for a short term. This follows from the definition of commercial residential premises referred to in para 18.

The ruling goes on to note in para 26 that the premises may be in any form, including detached buildings, semidetached buildings, strata-title apartments, single rooms or suites of rooms within larger premises.

Therefore, because a display home has all the physical characteristics that enable it to be used for residential accommodation the ATO considers that a lease of a house to be used as a display home will be an input taxed supply[13].

HOUSE & LAND PACKAGES AND SELLING "OFF THE PLAN"

Generally, purchase of a house and land package comprises two separate supplies. The first is for the purchase a block of vacant land and, assuming the property developer accounts for GST on an accruals basis, the GST will be attributed to the tax period in which settlement of the land occurs. The margin scheme will usually be available on this first supply[14].

The second part of the contract relates to the supply of building services. Because this part of the contract is not for the supply of real property the margin scheme cannot be used. Generally, progress payments are made after each stage of the construction process has been completed. As this part of the contract is being supplied on a progressive basis Div 156[15] should apply therefore GST will generally be attributed in the tax period in which progress payments are made.

Where a builder takes a deposit, Div 99 may apply if a term of the contract provides that the purchaser forfeits the deposit if he defaults under the contract[16]. If Div 99 applies, the GST on the deposit will be attributed to the tax period in which the deposit is forfeited. If Div 99 does not apply, the deposit will be treated as an

advance payment and Div 156 will attribute the payment to the tax period in which the deposit is paid[17].

In contrast to the previous discussion, the ATO takes the view in TD 18 that an "off the plan" purchase is a contract that contains a condition that the building works etc must be completed before the obligation to transfer title must be performed. The effect of TD 18 is that there is a single supply and the contract is made when it is executed not when the building works are completed. This means the developer can use the margin scheme on the full contract price.

It is not unusual for properties that are acquired "off the plan" to be on-sold before settlement with the developer. A common scenario for large inner city unit developments is for the developer to sell a number of premises "off the plan" to a marketing company (in order to reach pre-sales targets required by financiers). The marketeer will then on-sell the premises before they have to pay the balance of the purchase price. In this event the on-sale would be in the course of furtherance of an enterprise, and subject to GST if the marketeer was registered or required to be registered.

The on-sale amounts to a disposal (by way of assignment) of the marketeer's contractual right to the premises, not a supply of residential premises, therefore the on-sale will not be input taxed under s. 40-65. This is because the definition of residential premises means land or a building and this does not extend to a supply of contractual rights to acquire land or a building. However, the marketeer can use the margin scheme because "real property" means "any interest in or right over land or a personal right to call for or be granted any interest in or right over land".

An alternative strategy is for the marketeer to actually take delivery of title to the premises from the developer and enter into a separate contract to sell the premises to the new purchaser. In this event the on-sale to the new purchaser cannot take effect until the property developer transfers title to the marketeer however the sale by the marketeer will then be a supply of residential premises and therefore input taxed[18]. While the marketeer will be denied input tax credits on the original acquisition this will only be an issue if the developer didn't use the margin scheme.

CONCLUSION

My experience over the past six months is that there is still a lot of uncertainty amongst general practitioners in regard to many GST issues that affect property transactions. Hopefully this series of papers will at least serve to point readers in the general direction of the answers they need. However, this can be a complex area of law and I fear that it won't be long before a tax practitioner finds them self on the receiving end of a negligence claim.

For example, last month I was informed of a property acquisition where the contract provided for a GST inclusive price and specifically provided that the vendor could elect to use the margin scheme. There is nothing exceptional about this, however in this case the purchaser's tax adviser was not aware that a purchaser is denied an input tax credit when the margin scheme is used and had prepared cash flow forecasts and development budgets that anticipated receipt of a large input tax credit in regard to the acquisition. The purchaser is a property developer and to make matters worse, on the facts presented to me the developer could easily have restructured the transaction to take advantage of the subdiv 38-J exemption. While the long-term result will not change materially (because the developer will also be able to use the margin scheme – which would have been denied if the developer was entitled to input tax credits) this simple mistake creates significant short-term cash flow problems for this business. To the extent that this causes the developer an economic loss (and consequential losses could be significant) the adviser's professional indemnity policy is at risk. ◆

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Keith will feature as guest contributor on August TaxTape on the subject of Financial Services Reform

Reference Notes

1 s. 9-20.
2 s. 195-1 and s. 6(1), ITAA36.
3 City Council of Norwich [1995] BVC 714 at 716.
4 C & E Commrs v Morrison's Academy Boarding Houses Association (1977) 1 BVC 108.
5 Refer s 9-20 and MT 2000/1.
6 Refer paras 31 – 36 of GSTR 2001/7
7 In some circumstances sale of the single asset of an entity may not be excluded from the entity's turnover – refer GSTR 2001/7 paras 42-47
8 s. 118-B ITAA 1997
9 s. 9-75. Also refer to GSTR 2001/6 which considers how the grant of the right to develop the land should be valued.
10 s. 82-10(1)
11 s. 82-5(1)
12 s. 195-1 of the GST Act
13 Refer also to ID 2001/469
14 refer to p 474 of Taxation in Australia, April for a discussion of when the margin scheme is available
15 Supplies and acquisitions made on a progressive or periodic basis
16 refer to page 473 of Taxation in Australia for a discussion of the alternative treatments for forfeited deposits
17 refer paras 115 to 120 in GSTR 2000/35
18 This second sale is not a sale of new residential premises because the premises have previously been sold as residential premises when developer sold the premises to the marketeer.