New developments in GST: anti-avoidance and determining "residential premises"

VCE AND COMMISIONER OF TAXATION [2006] AATA 821 AND TOYAMA PTY LTD V LANDMARK BUILDING DEVELOPMENTS PTY LTD [2006] ATC 4160

VCE AND COMMISSIONER OF TAXATION

In its compliance program for the 2006–2007 income year, the Australian Taxation Office ("ATO") has indicated that it will further increase its GST compliance activities. It is interesting to note that whilst GST revenue constitutes approximately 15 per cent of all tax revenue collected by the ATO, collections from GST compliance activities make up approximately 25 per cent of all compliance collections[1]. The spate of GST cases heard in the Administrative Appeals Tribunal ("AAT") and the courts in September and October illustrates the Commissioner's tough stance on GST non-compliance.

In the case of *VCE and Commissioner of Taxation* [2006] AATA 821, the Commissioner of Taxation for the first time successfully applied the GST anti-avoidance provisions contained in Div 165 of the GST Act.

Background facts

The case concerned an arrangement whereby one of the shareholders ("Transferor") of the taxpayer company, VCE, transferred land to VCE for $770,000, inclusive of GST. The reasons for the transfer of the property were varied, and include asset protection and the provision of a benefit to the Transferor's wife, who was also a shareholder of VCE. The land was subject to a mortgage and was not actually valued as high as $770,000.

The purchase price was to be paid in four unequal instalments, with a deposit of $550 payable up-front and the bulk of the purchase price due on 30 June 2018. Legal ownership of the property was to pass to VCE on the payment of the final instalment in 2018.

The Transferor was registered for GST and elected to account for GST on a cash basis. Therefore the GST liability of $70,000 would only be payable when the cash was received in 2018. However, VCE, which was also registered for GST purposes, had elected to account for GST on an accruals basis. This meant that VCE would be entitled to the input tax credit when the tax invoice was issued, being when the arrangement was entered into. VCE lodged its first business activity statement ("BAS") for the April 2003 tax period showing capital purchases of $770,000 and the entitlement to an input tax credit of $70,000.

The Commissioner sought to apply Div 165 to the arrangement. In doing so, he cancelled the input tax credits of $70,000 and sought to levy penalties of $35,000. In an appeal to the AAT, VCE argued that Div 165 of the GST Act did not apply and that the transaction represented an ordinary commercial or family dealing.

Relevant legislative provisions

Division 165 of the GST Act is similar to Part IVA of the *Income Tax Assessment Act 1936* ("ITAA 1936"), and applies to any scheme where an entity ("the avoider") obtains a GST benefit (which is not obtained under a valid GST election or choice) and (after taking into account a number of objective factors) it can be concluded that:

- an entity (not necessarily the avoider) entered into the scheme for the sole or dominant purpose of the avoider obtaining the GST benefit; or
- the principal effect of the scheme was that the avoider obtained the GST benefit.

A GST benefit is defined in s 165-10 to arise where:

- an amount that is payable by an entity is smaller than it would be apart from the scheme;
- an amount that is payable to an entity is larger than it would be apart from the scheme;
- all or part of an amount that is payable by the entity is payable later than it would have been apart from the scheme; or
- all or part of an amount that is payable to the entity is payable earlier than it would have been apart from the scheme.

AAT decision

The AAT agreed with the Commissioner and concluded that Div 165 applied to the arrangement. The AAT held that there was a scheme for the purposes of s 165-10 and the sole or dominant purpose of the taxpayer or the vendor in entering into the scheme was to enable the taxpayer to obtain a GST benefit. In a relatively detailed decision, the AAT accepted that had the scheme not been entered into, the Transferor would not have sold the property to VCE in the first place.

The consequence of the scheme was that GST became attributable to the April tax period. As the Transferor accounted on a cash basis he only became liable to pay GST on the $550 he actually received in that tax period. However, VCE became entitled to claim an input tax credit for the full amount of the consideration payable. In other words, payment of the bulk of the GST liability was deferred for 15 years but was immediately refundable to VCE. The benefit of the taxpayer only came about because of the terms of the agreement between the parties.

In the absence of Australian authorities on Div 165 of the GST Act, the AAT referred extensively to cases on Part IVA of the ITAA 1936, finding that the principles contained in the two provisions were very similar. The tribunal concluded that "even if a person were not familiar with Part IVA of the ITAA 1936, it is apparent from the scheme of the GST Act that there is meant to be some degree of conformity between the GST that is paid and on a taxable supply and the input tax credit on that taxable supply".

The AAT then went on to analyse whether the benefit arose under a GST election, the various objective factors outlined in the legislation, and the dominant purpose of the scheme. All pointed to the scheme being in breach of Div 165, thereby allowing the Commissioner to cancel the input tax credits in their entirety.

The AAT further concluded that there was no basis on which to remit the penalty imposed under s 284-15(1) of the *Taxation Administration Act 1953* (Cth) of 50 per cent of the scheme shortfall amount. According to the tribunal, the taxpayer did not have a reasonably arguable position and the fact that that reasonable care was taken in preparing the BAS was not relevant to the imposition of the penalty.

Comments and implications of case

VCE and Commissioner of Taxation is a significant GST case, not because of the dollars involved, but rather because it is the first Australian authority on the application of the GST anti-avoidance provisions. However, it will also have significance in relation to the operation of Part IVA of the ITAA 1936 (due to the similarities between the provisions). Readers should note that the type of transaction in dispute in *VCE and Commissioner of Taxation* was in fact highlighted by the Commissioner in Taxpayer Alert TA 2004/1, which was issued in January 2004. The decision of the AAT in this case confirms the Commissioner's view in that document that arrangements utilising cash and non-cash accounting methods to obtain a GST benefit would be subject to Div 165 of the GST Act.

Whilst Div 165 is slightly different in drafting to Part IVA (eg Part IVA has no equivalent to the "principal effect" condition outlined above) much of the wording is similar, and it would appear that the courts and tribunals would undertake a similar kind of analysis when approaching both provisions. Further, given the increasingly large number of cases in which the Commissioner has successfully applied Part IVA, if this is anything to go by, it appears that Div 165 will prove equally as powerful a weapon for the Commissioner as Part IVA.

TOYAMA PTY LTD V LANDMARK BUILDING DEVELOPMENTS PTY LTD

The decision of the Full Federal Court in *Marana Holdings Pty Ltd v FCT* (2004) 57 ATR 521 created uncertainty in relation to whether the supply of some properties was subject to GST or instead qualified to be input taxed. The decision created significant uncertainty as to which types of properties could be classified as "residential premises" and therefore qualified to be input taxed rather than being supplies subject to GST. The Full Federal Court in *Marana Holdings* held that for real property to constitute residential premises, it must be occupied or intended to be occupied and capable of being occupied as a residence, in that there must be a permanent or at least long-term commitment to occupy those premises. Whether the premises are intended to be occupied as a residence requires an analysis of the objective intention with which the premises in question were designed, built or modified.

In the case of *Toyama Pty Ltd v Landmark Building Developments Pty Ltd* [2006] ATC 4160, the New South Wales Supreme Court revisited the issue of what constitutes residential premises with an unexpected outcome.

Background Facts

Landmark Building Development Pty Limited ("Landmark") and Toyama Pty Ltd ("Toyama") were co-owners of property under a joint venture. The property was acquired in 1998 and included a house with two residences. A director of Landmark stayed on the premises from time to time during holiday periods and on weekends. Further, one of the residences was leased for 6 months in 1999 and for 13 weeks between in 2001 to 2002.

Following a breakdown in the joint venture relationship, trustees were appointed to sell the land owned by the parties. At the time of the appointment, the house on the land was disused, however development consent had been obtained from the local council for the demolition of the existing structure and the construction of a 14-unit development. In accordance with taxation advice obtained by the trustees, the contract of sale provided that the sale was a taxable supply under the GST Act. The property was marketed as a development site and sold to a developer for $2,760,000 inclusive of GST. The trustees were registered for GST purposes.

Landmark claimed that the sale was a supply of residential premises and therefore not subject to GST. Under s 40-65 of the GST Act, the sale of residential premises that were not new were not subject to GST if the premises were real property "to be used predominately for residential accommodation". Relying on paragraph 19 of GSTR 2000/20 and the decision in *Marana Holdings*, Landmark argued that as there was a house constructed on the land which included all the facilities necessary for residential accommodation, such as bedrooms, a lounge room, kitchen, bathrooms, laundry and so on, the trustees supplied residential premises to be used predominately for residential accommodation. Landmark submitted that it was irrelevant that the land was marketed as a development site in the expectation that the existing building would be demolished, and it was irrelevant that the purchaser bought the land with the intention of demolishing the house and constructing new apartments.

Landmark claimed that, as a result of

the trustees' mistake in describing the sale as a taxable supply, the trustees should remit 1/11th of the purchase price to the purchaser. Further, as the trustees acted in breach of trust, they were liable to compensate Landmark for its share of the loss occasioned by the breach, namely 1/11th of the sale price. Landmark subsequently obtained a private ruling from the ATO that the sale was an input taxed supply because the property was residential premises to be used predominately for residential accommodation. The ATO later confirmed this view in a second private ruling sent to the trustees after they corrected certain information given to the ATO in relation to the first private ruling. The ATO also advised the trustees to cancel the tax invoice and return the GST incorrectly collected to the purchaser.

Landmark also submitted that the sale was not a taxable supply because it was not made in furtherance of an enterprise carried on by the trustees and that it was open to the trustees to refer to the private rulings of the ATO in proceedings to which the Commissioner was not a party.

Decision of the New South Wales Supreme Court

Landmark's application for breach of trust was dismissed.

White J of the New South Wales Supreme Court held that the trustees carried on an enterprise within the meaning of the GST Act, being a series of activities done in the form of a business. The enterprise which the trustees carried on was a series of activities required to be undertaken pursuant to their appointment as trustees for sale. The sale of the property was in furtherance of that enterprise.

The court also held that the sale was not one of residential premises to be used predominately for residential accommodation. White J distinguished *Marana Holdings* on the grounds that the case did not consider how the words "to be used predominately for residential accommodation" in s 40-65(1) are to be construed. White J held that the words "to be used predominately for residential accommodation" requires a prediction as to the future use of the premises. The most important factor in such a prediction is the intention of the future owner or lessee of the property. In the case of a lease, the question *of how* the property is to be used in the future will usually be determined by the terms of the lease. In the case of a sale, the likely future use of the property will probably depend on the purchaser's intentions, to be assessed having regard to objective circumstances such as the physical condition of the premises, zoning or any restrictive covenants.

In White J's view, it does not accord with the natural meaning of s 40-65(1) to determine the question of whether the residential premises are to be used predominately for residential accommodation, solely by reference to the physical construction of the premises, and what that construction connotes about the intention with which the premises were designed, built or modified. If that construction were correct, it would have been much simpler for Parliament to have provided that a sale of real property was input taxed to the extent that the property was constructed as a residence. It is necessarily implicit in the expression "residential premises to be used predominately for residential accommodation" that premises constructed as a residence may not be used for that purpose. Rather s 40-65(1) recognises the possibility of dual or multiple uses of a building constructed as a residence. Hence the construction of the premises cannot be determinative of their intended or expected use.

The most important factor in making a prediction as to how relevant premises would be used was the *intention of the purchaser* of the premises. The fact that it may be difficult to assess how premises would be used in the future did not mean that the range of available materials for making that assessment should be limited by excluding the most important consideration.

Even if the matter of how the premises would be used was to be determined solely by objective criteria, there was no warrant for limiting those criteria to the physical characteristics of the premises at the time of the supply. In the present case, the objective criteria for determining whether premises would be used predominately for residential accommodation included its location, the configuration of the site, the fact that development consent had been granted for the construction of residential apartments, and the fact that at the time of sale the building was disused. These criteria showed that, notwithstanding that the land had on it a building that was constructed as a residence, it was not likely that the premises would be used predominately for residential accommodation. Accordingly, White J was of the view that the trustees were correct in describing the sale as a taxable supply. Although the existing building was constructed as a residence, which made it "residential premises", the purchaser did not intend to use the land and building for residential accommodation. Rather, the intention was to demolish the existing building.

As the trustees acted correctly, the Court was of the view that there was no breach of trust.

Conclusion and implications of case

The New South Wales Supreme Court in *Toyama* appears to have reverted to a subjective analysis in determining whether premises constitute residential premises. This is clearly contrary to the Full Federal Court's decision in *Marana Holdings*. If the principles decided in *Toyama* are followed, it will have a significant GST impact on the sales of residential properties. This decision raises some difficult issues for property developers, in particular, that the vendor of a property has to take account of the purchaser's likely use of the property when determining the GST treatment of the sale. The result of this is that many sales of existing residential property by registered businesses to property developers will be taxable, even though this appears to be contrary to the policy of the GST law for residential property.

The *Toyam*a case also serves as a warning to taxpayers to provide sufficient and correct facts to the ATO when seeking a private ruling. As the case demonstrates, where the ATO is not provided with sufficient or correct facts, any private ruling obtained cannot be relied upon and is not binding on the Commissioner.

Readers should note that new legislation was passed on 30 June 2006 which has affected the meaning of "residential premises" and will apply retrospectively from 1 July 2000. The definition of residential premises analysed in the Toyama case was repealed and replaced with a new provision:

Residential premises means land or a building that:

(a) is occupied as a residence or for residential accommodation; and

(b) is intended to be occupied; and is capable of being occupied, as a residence or for residential accommodation.

(regardless of the term of occupation or intended occupation) and includes a floating home.

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Reference notes

1 Australian Taxation Office "2006-07 Compliance Program" at page 2