

Court questions what is a “supply” – forfeited deposits

RELIANCE CARPET CO PTY LTD V COMMISSIONER OF TAXATION [2007] FCAFC 99



INTRODUCTION

In 2006 the Administrative Appeals Tribunal found in *Reliance Carpet Co Pty Ltd v Commissioner of Taxation*,¹ that GST was payable by a vendor on a deposit forfeited by the purchaser under a Victorian sale of land agreement where the agreement had been rescinded due to the purchaser’s breach. In determining that GST was payable, the Tribunal identified “interim” supplies made by the vendor prior to completion of the contract and also supported the Commissioner’s argument that s 99-10 of the GST Act was a deeming provision.

On 5 July 2007, the Full Federal Court unanimously allowed the taxpayer’s appeal from the decision of the Administrative Appeals Tribunal (“Tribunal”). The Court found that the vendor had not made any interim supplies and that s 99-10 was not a deeming provision.

THE FACTS

Reliance Carpet Co Pty Ltd (“**taxpayer**”) is the registered proprietor of commercial land in Victoria (the “**Property**”). In January 2002 the taxpayer entered into a contract for the sale of the Property to a third party for \$2,975,000 plus GST. Under the contract, the purchaser was required to pay a deposit of 10 per cent of the purchase price. The agreement also provided that the provisions of Table A of the *Transfer of Land Act 1958* (“**Table A**”) were incorporated in the contract, which contains default, rescission and forfeiture provisions.

Settlement of the sale was due to occur on 10 July 2003. However the purchaser failed to pay the balance of the purchase price on that date. As a result of the purchaser’s default,

the taxpayer issued a notice to the purchaser and subsequently rescinded the contract and retained the deposit as liquidated damages pursuant to General Condition 6 of Table A.

In early 2004 the purchaser requested a tax invoice for the amount of the forfeited deposit. The taxpayer’s legal advice was that it could not provide a tax invoice as it had not made a taxable supply of anything to the purchaser.

In November 2004 the Commissioner assessed the taxpayer as being liable to pay GST in respect of the forfeited deposit in the tax period in which the contract was rescinded. In due course the taxpayer objected to the assessment but this objection was disallowed. The taxpayer sought a review of the Commissioner’s decision to disallow its objection.

RELEVANT LEGISLATIVE PROVISIONS

GST is payable on “taxable supplies”². A person makes a taxable supply if, among other requirements, that person makes a *supply for consideration*³. GST is payable by the supplier on any taxable supply that it makes⁴.

Division 99 of the GST Act provides special rules for dealing with deposits:

99-5 Giving a deposit as security does not constitute consideration

- (1) A deposit held as security for the performance of any obligation is not treated as consideration for a supply, unless the deposit:
- a) is forfeited because of a failure to perform the obligation; or
 - b) is applied as all or part of the consideration for a supply.
- ...

99-10 Attributing the GST relating to deposits that are forfeited etc.

- (1) The GST payable by you on a taxable supply for which the consideration is a deposit that was held as security for the performance of an obligation is attributable to the tax period during which the deposit:
- a) is forfeited because of a failure to perform the obligation; or
 - b) is applied as all or part of the consideration for a supply.

THE TRIBUNAL’S DECISION

The Tribunal considered whether the taxpayer made a supply when it rescinded the contract of sale and forfeited the deposit. It then looked to see if any other supplies had been made and whether there was a sufficient nexus between the other supply and the forfeited deposit such that the supply was made *for consideration*. The Tribunal also considered whether the forfeited deposit was properly liquidated damages and therefore not consideration for a supply.

The Tribunal agreed with the taxpayer that it had not made a supply when it rescinded the contract of sale. Therefore the taxpayer could not have made a *taxable* supply.

However, the Tribunal was not satisfied in relation to whether the deposit was consideration for the rescission, as the deposit was not paid “in connection with” the rescission. The Tribunal noted that, following the execution of the contract the taxpayer entered into a number of obligations within the meaning of s 9-10(2)(g) of the GST Act:

- the ultimate obligation was to transfer title to the Property to the purchaser upon

receipt of the balance of the purchase price,

- maintain the Property in its current condition until completion;
- pay all rates, taxes, assessments, fire insurance premiums and other outgoings in respect of the Property until completion; and
- hold the existing fire insurance policy for itself and in trust for the purchaser to the extent of their respective interests.⁵

The Tribunal held that upon assuming these obligations the taxpayer made a supply for GST purposes and that it accepted the deposit as consideration for that supply. However, because of s 99-5 GST is not attributed to the consideration until the deposit is either forfeited or applied as all or part of the consideration for the supply.

Upon the taxpayer's rescission of the contract and the forfeiture of the deposit, "the protection afforded by s 99-5 no longer applied" and the payment of the deposit was therefore treated as a consideration for a supply attributable to the tax period during which the forfeiture occurred pursuant to s 99-10.⁶

It was agreed between the parties that all the other conditions required to make a taxable supply were present. Therefore it followed from the Tribunal's decision that the taxpayer was liable to GST on the deposit retained by it.

Further, the Tribunal found against the taxpayer on the question as to whether the forfeited deposit amounted to liquidated damages as it was not calculated as a genuine pre-estimate of the damages likely to be suffered by the taxpayer in the event of the purchaser's breach, nor was it agreed to as such by the purchaser.

THE APPEAL

The parties agreed that this case should proceed straight from the AAT to the Full Federal Court, and the Court gave leave to hear the appeal.

Taxpayer's submissions

The taxpayer appealed the decision of the Tribunal to the Full Federal Court on the basis that there is no identifiable supply to which the forfeited deposit relates.

The taxpayer's primary contention was that the contract of sale is only a single "supply" within the meaning of the GST Act, namely the supply of the real property. In this regard, the intermediate obligations imposed on both parties under the contract of sale were ancillary to the supply of real property and did not constitute separate supplies in their own right. The taxpayer strongly argued that the interpretation of the transaction as a single supply is consistent with commercial reality, and that any finding in the alternative would lead to an absurd result that conflict with the purpose and context of the GST Act.

In the alternative, the taxpayer submitted that:

1. the deposit was part of the payment of the supply for the Property but subject to s 99-5 of the GST Act, an act which defers attribution of GST until the deposit is applied as consideration for a supply of something (usually supply of the land at completion, however other examples were given), and in this case no supply was made; and
2. the deposit was itself a financial supply made by the purchaser to the taxpayer being an "earnest or guarantee of performance of the purchaser's obligations under the contract". In this event, upon forfeiture of the deposit no supply moves from the taxpayer to the purchaser. The purchaser has entered into obligations including granting the taxpayer the contractual right to retain the deposit upon default. For a supply to be identified, the taxpayer submitted that there must have been something done for the purchaser rather than against the purchaser, which did not occur in the present case.
3. the definition of "supply" in the GST Act does not extend to the exercise of an existing right by a party to a contract, nor does it extend to a discharge of any obligation by the act of payment.
4. the forfeited deposit represents a payment in the nature of damages, which the ATO accepts is not consideration for a supply under the GST Act. The taxpayer argued that there is a clear intention that a deposit is to compensate the vendor for the many possible losses the vendor may suffer where the contract is rescinded.

Commissioner's submissions

The Commissioner submitted that the forfeited deposit was consideration for a supply made by the taxpayer as either:

1. a supply of one or more of the taxpayer's rights and/or obligations under the contract prior to rescission. The refund of the deposit is not a supply. The obligations arising under the contract are each a supply under the wide definition of "supply" in s 9-10 of the GST Act, which, upon settlement of the contract, would have merged to form part of the supply of the land, and that such interpretation does not result in absurdities; or
2. a supply of one or more of the taxpayer's rights and/or obligations arising from the rescission of the contract. The Commissioner argued that on and from the date of rescission, the taxpayer created and surrendered rights in relation to the land, entered into obligations in favour of the purchaser regarding the rescission and released the purchaser from other obligations under the contract (including the obligation of performance)⁷ and these actions fall within the wide meaning of "supply" in the GST Act; or
3. a supply deemed to occur upon forfeiture of a deposit by operation of Division 99 of the GST Act. In this regard the Commissioner argued that it would be pointless if Div 99 only regarded forfeited deposits as "consideration" rather than "consideration for a supply" and such interpretation is consistent with the Explanatory Memorandum of the GST Act⁸.

DECISION OF THE FULL FEDERAL COURT

The Court⁹ unanimously:

- upheld the taxpayer's primary submission that a contract of sale of land is a single supply of the legal property interest and should not be unpacked.
- upheld the taxpayer's submission that the concept of supply requires some act of provision, furnishment, conferral or giving of something or enter into an obligation to do something, refrain from doing or to tolerate a situation.
- rejected the Commissioner's submission that the forfeited deposit was consideration for the vendor rescinding the contract and bringing certain

obligations to an end and held that the purchaser was the party that rescinded the contract when it failed to comply with its obligations under the rescission notice;

- held that the mere extinguishment of a contractual right would not come within the ordinary meaning of supply.
- rejected the Commissioner's construction of the meaning of Div 99.

The Court referred to the logic applied by Dixon J in *Hallstroms Pty Ltd v Commissioner of Taxation*¹⁰ and a different Full Federal Court¹¹ in *Commissioner of Taxation v Raymor (NSW) Pty Ltd*¹² and adopted the reasoning in *Westley Nominees*¹³ where the Court held that it was artificial to regard each obligation arising under the contract of sale as a separate supply for which the deposit may be consideration. Although each right or obligation arising under the contract may make up part of the overall transaction, such analysis does not assist the Court to resolve the issue before it:

"When the [taxpayer] entered into the contract for sale with the purchaser it entered into a contract for the supply of real property; nothing more and nothing less... That supply did not take place because the contract was rescinded. However, the fact that the supply did not take place is not a warrant to undertake some juristic dissection of the contract to find some other supply... In our view, there was no supply of interim obligations either then or subsequently."¹⁴

The Court rejected the Commissioner's submission that the forfeited deposit was consideration for a supply made by the taxpayer as a supply of one or more of the taxpayer's rights and/or obligations arising from the rescission of the contract. In the Court's opinion the mere extinguishment of contractual rights would not fall within the ordinary meaning of "supply". In any event, the Court did not regard the taxpayer as having extinguished any rights or released the purchaser from any obligations under the contract by issuing a rescission notice. These rights and obligations were instead extinguished by the purchaser's failure in remedying the default in accordance with taxpayer's rescission notice.

The Court also rejected the Commissioner's interpretation of Div 99 and held that that

at best s 99-5 would allow a forfeited deposit to be treated as consideration for an unidentified supply. But if the supply can not be identified then s 99-5 has no work to do. The Court should not "give a strained construction" of the meaning of supply where the ordinary meaning of that term has already been stretched by the language in s 9-10(2).

The Court regarded its interpretation of Div 99 to be consistent with the legislative purpose of the GST Act being to impose a tax on supplies. On this point the Court referred to the Executive Summary of the Explanatory Memorandum and the Full Federal Court Decision¹⁵ in *Sterling Guardian Pty Ltd v Commissioner of Taxation*¹⁶ which said:

"In economic terms it may be correct to call the GST a consumption tax, because the effective burden falls on the ultimate consumer. But as a matter of legal analysis what is taxed, that is to say what generates the tax liability (and the obligations of recording and reporting), is not consumption but a particular form of transaction, namely supply; see generally *H P Mercantile Pty Ltd v Commissioner of Taxation (2005) 143 FCR 553* at [10] – [15]."

CONCLUSION AND IMPLICATIONS OF CASE

The decision of the Federal Court confirms many overseas decisions that GST transactions must be viewed in light of their overall commercial reality, rather than being artificially unpacked to achieve certain outcomes. In the *Reliance Carpet* case it is clear that the contract of sale entered into by the taxpayer and the purchaser was a single supply that could not be dissected so that each interim right or obligation arising under the contract of sale could each constitute a separate supply under the GST Act.

The Court also sent a reminder that the roles of the judiciary and parliament must remain fundamentally separate, stating that the

"language of the statute cannot be "massaged" through the application of modern principles of statutory construction to accommodate the legislative purpose identified through the statute itself and permissible extrinsic materials".

Ultimately, the Court noted that if the parliament had intended that forfeited

deposits were to be subject to GST, then the relevant provisions in the GST Act should have been worded to allow the text of the statute to be interpreted as such.

And in the writer's respectful opinion the Court's interpretation of s 99-5 is entirely consistent with the paragraph of the GST Act Explanatory Memorandum that was cited by the Commissioner¹⁷. Contrast the facts in *Reliance Carpet* with a situation where a deposit is taken upon hiring a lawn mower. In this instance the bailee has received a supply of something (possession and use of the mower) in the event the deposit is forfeited because, say, the mower is not returned or is damaged. In this example s 99-5 will, and should, attribute GST to the forfeited deposit. The owner has supplied the use of goods to the bailee, the owner will have to make good the loss or damage it has suffered and will claim input tax credits on this cost. The owner recovers the make good cost from the deposit and pays GST on this amount. This type of situation must be distinguished on its facts from the circumstances arising in *Reliance Carpet*.

Keith Harvey
Principal

Reference notes

- 1 [2006] AATA 486 (AAT, Olney DP, 5 June 2006).
- 2 S. 7-1(1) A New Tax System (Goods and Services Tax) Act 1999 (the GST Act)
- 3 S. 9-5 of the GST Act
- 4 S. 9-40 of the GST Act
- 5 At paragraph 17.
- 6 At paragraph 20.
- 7 Note: the taxpayer specifically reserved its right to sue the purchaser for any further loss or damage that it suffered as a result of the breach of contract and subsequent rescission.
- 8 See [6.166].
- 9 Heerey, Stone and Edmonds JJ
- 10 (1946) 72 CLR 634 and 648.
- 11 Davies, Gummow and Hill JJ
- 12 (1990) 24 FCR 90
- 13 (2006) 152 FCR 461
- 14 [2007] FAFC 99 at [17].
- 15 Heerey, Dowsett and Conti JJ
- 16 (2006) 149 FCR 255
- 17 Paragraph [6.166]