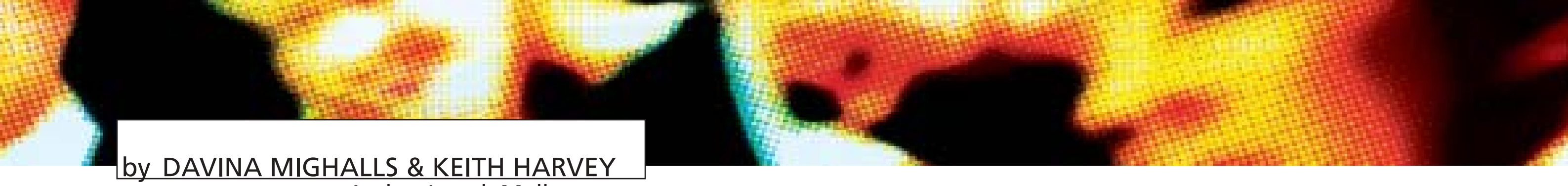

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When will the supply of a Going Concern be GST-Free?

ATO responds to industry concerns

INTRODUCTION

The ATO have released a new GST ruling, 2002/5, explaining when a supply of a going concern will be GST-free. This ruling replaces GSTR 2001/5, which ceased to have effect on 15 October 2002. Practitioners should note that where the supply of a business predates the release of GSTR 2002/5 the supply should be treated in accordance with the ATO's position in GSTR 2001/5.

WHAT HAS CHANGED?

GSTR 2002/5 addresses the concerns of industry groups and evidences a change in the ATO's position on the following:

- Franchises – a surrender of the rights under a franchise agreement in favour of the purchaser of the business will be taken as a supply of the rights under the franchise by the vendor, provided a new agreement is entered into by the franchisor and the purchaser;
- Mortgagee sales – the ATO now differentiates between circumstances where a creditor is acting as an agent for a debtor and where they are not, such that mortgagees can obtain the benefit of the going concern exemption notwithstanding Division 105;[1]
- Partnerships – the GST status of the supplies that are made on formation of a partnership will now depend on the facts and circumstances surrounding the supplies in question;
- Staff – the ATO now accepts that staff are not things capable of being supplied, therefore all that a vendor must do is take all reasonable steps to facilitate the transfer of particular skills and knowledge of key employees;
- Supply of licences, quotas & permits – the ATO has now addressed circumstances where a vendor chooses to surrender a licence, permit or statutory authorization and request that it be reissued to the purchaser of a business by the relevant entity; and
- Supply of premises used by the enterprise – the ATO have clarified how the supply of alternatively leased premises will be regarded.

These changes are discussed in more detail below.

KEY ELEMENTS

Arrangement

For the purposes of subdivision 38-J, a supply of a going concern includes a supply under a single contract or multiple supplies under multiple contracts that comprise a single arrangement. It is only required that the things supplied under the arrangement relate to the same enterprise.

What constitutes an enterprise?

An enterprise is widely defined in s 9-20 to include an activity or series of activities –

- done in the form of a business (the term "business" takes on its ordinary tax meaning); or
- in the form of an adventure or concern in the nature of trade (for example, a one off transaction that would not amount to conducting a business); or
- on a regular or continuous basis, in the form of a lease, licence or other grant of interest in property (for example, the leasing of commercial premises).

Case Study – leasing of premises

AccountsCo is an entity that owns the building from which it operates its accountancy practice. It enters into a contract to sell the building to Rental Properties Trust and agrees to enter into an agreement to lease the building back from the trust. It does not at any time conduct an enterprise of leasing the premises.

AccountsCo did not, and was not able to, conduct an enterprise of leasing the building to itself prior to the day of the supply. This means that upon sale of the premises it merely supplied Rental Properties Trust with an asset used by AccountsCo in the conduct of its enterprise. Even though the purchaser carried on an enterprise of leasing, the supply of the premises was not the supply of a going concern, as no enterprise of leasing had been carried on by the vendor.

Independent operations

A vendor may conduct an enterprise that is part of a larger enterprise. If all of the things necessary to continue the operation of that part of the enterprise, as an independent enterprise, are supplied there will be a supply of a going concern.

Paragraph 37 of GSTR 2002/5 provides the following indicia of an independent operation:

- a degree of autonomy;
- a separate budget;
- a separate management structure;
- a system of internal user charging; and
- agreements with internal service providers or external customers.

Case Study – independent operation

SteelCo is a manufacturer of steel products, which uses a large amount of electricity for its processes. SteelCo has its own power generation plants to ensure that it has sufficient and consistent electricity supplies at all times. The power generation operation is a separate division with substantial operations, distinct from those of SteelCo. The power generation division has a separate management structure, with a system of internal user charging for the power it supplies to other SteelCo divisions under internal service agreements. Last year the division generated 10 per cent of its revenue from external customers.

SteelCo sells the power generation division to an independent power provider. It transfers the plant and premises used in power generation, the benefits of existing contracts with external suppliers & customers, the separate management structure, and facilitates the transfer of necessary employees. As part of the sale agreement, the power provider enters into a contract to provide SteelCo with electricity.

As the power generation division is conducted as a separate and distinct operation, the activities of that division are an enterprise. For there to be the supply of a going concern, SteelCo must conduct the activity of power generation up to the day of the supply and supply all of the things that are necessary for the continued operations of the division to the purchaser.

What is meant by the phrase ‘the supplier supplies’?

The tests that must be met for the sale of an enterprise to be GST free as the sale of a going concern are set out in s 38-325(2). It must be noted that these tests must be satisfied from the perspective of the vendor. The ability of the purchaser to provide some of the things necessary for the continued operation of the enterprise is irrelevant. Also, the vendor cannot cause a related entity to supply some of the things necessary. For example, where a sole trader uses premises, plant or equipment owned by a service trust the sole trader will be unable to provide all of the necessary things unless the sole trader has a contractual right to use the assets which is capable of being assigned to the purchaser.

Things that the vendor can supply

The things that are necessary for the continued operation of an enterprise will vary according to the nature of the enterprise and the thing supplied. The Commissioner now accepts that in some circumstances, it may not be possible for a vendor to transfer or convey some of the things necessary for the continued operation of the enterprise.

Examples include:

- certain employment contracts;
- franchise agreements;
- licences which must be surrendered before a new licence is issued.

The ATO’s new position is that where the relevant thing is rights under an existing contract, the subdiv 38-J test will be satisfied if the vendor surrenders those rights in circumstances where the third party has, or it is highly probable that it will, enter into a contract with the purchaser containing substantially similar rights.

Where there is a statutory or legal impediment to the vendor supplying these things:

- the vendor must make all reasonable efforts to have the thing supplied to the purchaser; and
- the supply must be by a statutory authority, or the other party to the contract with the vendor; and
- the thing must actually be supplied to the purchaser by the third party.

Case Study – surrender of a licence is sufficient

TreesGone conducts an enterprise of removing dead trees and it is required to have a licence from the relevant State authority to remove native trees that have died. The licence is not able to be transferred to another entity without the permission of the issuing authority. Approvals of transfers are generally not given, however when a licence is surrendered, it is usually reissued to the potential transferee in all but exceptional circumstances. TreesGone enters into an agreement with TreesTake to sell the tree removal enterprise and supplies all the things that are necessary for the continued operation of the enterprise, other than the licence. TreesGone surrenders the licence and requests that the licence be reissued to TreesTake.

As there was a statutory impediment to transfer of the licence, and TreesGone made all reasonable efforts to have the licence transferred, the surrender of the licence and its reissue to TreesTake will satisfy the requirement that the vendor has supplied all the necessary things.

Where there is no statutory or legal impediment:

- it must be normal commercial practice for supply to be effected in this way; and
- the vendor conditionally terminates or surrenders their right and facilitates the entry into a new arrangement between the purchaser and the other party; and
- the thing is actually supplied to the purchaser by the other party to the contract.

For example: the ATO now accepts that where an enterprise is operated from leased premises it is not unusual for the landlord to allow the vendor to surrender its rights under the lease in exchange for the landlord granting the purchaser a new lease over the premises, therefore it is not necessary for the vendor to assign the old lease to the purchaser for the purposes of satisfying the going concern tests.[2]

ALL OF THE THINGS THAT ARE NECESSARY FOR THE CONTINUED OPERATION OF AN ENTERPRISE

The things that are necessary will depend on the nature of the enterprise and will not refer to every possible thing that might be used. For example, access to public telephone systems is not usually a thing which must be supplied by the vendor.[3]

A thing is considered to be necessary if the purchaser could not operate the enterprise without it. The new ruling explains this requirement by identifying two classes of things that must be supplied for the continued operation of an enterprise:

- The necessary physical assets for the enterprise to continue operation, such as premises, plant & equipment, goodwill, contracts, etc; and
- The intangible operating structure and process of the enterprise, such as ongoing advertising and promotion.

The intentions of the purchaser are not relevant in determining if a particular supply is that of a going concern. The purchaser may continue to conduct the enterprise as part of another enterprise, as a different enterprise, or not at all. However, it should be noted that div 135 creates an increasing adjustment for the purchaser if a going concern is used to make input taxed supplies. For example, using a mansion acquired as part of buying a reception enterprise to make an input taxed supply of residential accommodation.

Premises that are necessary

Attributes of particular premises may render them necessary to be supplied. For example, premises may have been modified to support heavy machinery or accommodate the height of equipment. In these circumstances, the characteristics of the building itself are such that those *particular* premises are necessary for the continued operation of the enterprise.

Where an enterprise must be conducted from premises, but *particular* premises are not necessary, then suitable premises, or the right to occupy such premises, must be supplied as one of the things that are necessary for the continued operation of the enterprise. Even if the purchaser is able to secure alternative premises, the Commissioner is of the view that the vendor will still not be supplying all things necessary for continued operation of the enterprise if it did not supply the original premises. However, the Commissioner now makes one important concession on this point which is explained in the new ruling by the following case study:

Case Study – supply of alternative premises

97. Apothecary Co conducts a pharmacy business from leased premises located on an arterial road. Newfellow Co enters into negotiations to acquire the pharmacy business but does not want to operate from the same premises as are currently used. A new shopping centre operated by Centre Co is about to open in the same suburb and Newfellow Co has indicated that it would prefer to operate the pharmacy business from a site within the new shopping centre.

98. Apothecary Co enters into a tripartite agreement with Newfellow Co and Centre Co under which (i) Apothecary Co will sell its pharmacy business to Newfellow Co; (ii) Newfellow will enter into a lease of premises from Centre Co; and (iii) Centre Co will grant a lease in favour of Newfellow Co. The granting of a lease of premises within the shopping centre is a condition precedent to the sale of the pharmacy business.

98. As the agreement for a lease of alternative premises is enforceable by Apothecary, Apothecary has supplied a right to occupy suitable premises to Newfellow. Apothecary will not be required to supply the premises which it currently occupies as a 'thing necessary for the continued operation' of the pharmacy business.

Statutory licences, permits, quotas or similar statutory authorisations

Some industries may require licences or permits, or may be subject to quotas or statutory allocations. Although a vendor may seek to satisfy the supply requirement by making all reasonable efforts, if the thing is not supplied to the purchaser in fact, this requirement will not be satisfied, rendering the vendor liable for GST.

GSTR 2002/5 has expanded upon the ATO's original view so that a vendor may supply the thing either by:

- Transferring it; or alternatively
- By surrendering their right to it, on the basis that it be reissued to the purchaser of the enterprise.

Franchises

The benefit of a franchise agreement is a thing that is necessary for the continued operation of an enterprise. Restrictions will often be imposed under the franchise agreement on the ability of the franchisee to transfer or assign the benefit of the franchise agreement. If either the franchise agreement itself does not allow a transfer, or permission to transfer the agreement is withheld by the franchisor, or the purchaser wishes vary the agreement (for example, to extend the term), a surrender of the rights under the agreement in favour of the purchaser will be taken to be the supply of the agreement, provided a new agreement is entered into by the franchisor and the purchaser.

Staff

Services of employees are necessary for the operation of many enterprises. Although these contracts are personal service contracts, and are incapable of assignment under the general law, GSTR 2001/5 still maintained that the benefits of the contracts was a necessary thing that must be supplied. The ATO's amended position is that neither staff nor their contracts of employment have to be supplied, and that it is not the key employees themselves that are necessary. GSTR 2002/5 reflects commercial reality such that the vendor must merely take all reasonable steps to facilitate the transfer of such skills and knowledge utilised by key employees in the enterprise. It now appears that the ATO's view is that in most, if not all, circumstances whether or not staff are supplied is irrelevant.

Supply of things in addition to those necessary for the continued operation of an enterprise

When an enterprise is sold, often things are supplied that are in addition to those necessary for the continued operation of the enterprise. The arrangement between the vendor and purchaser may consist of multiple supplies – those which will be GST-free because they relate to things that form part of the enterprise and those which will not benefit from the going concern exemption as they are not used in the enterprise. The relevant "arrangement" for the purposes of s 38-325 will only extend to the things used in the enterprise. In such cases, apportionment of the GST-free part and the taxable part of the arrangement must occur in accordance with the method of apportionment provided in s 9-80.

SPECIFIC ISSUES FACING PRACTITIONERS

Supply of parts of an existing enterprise to two or more purchasers

Supply of parts of an existing enterprise to two or more purchasers may constitute the supply of a going concern, provided that the two or more different parts are capable of separate independent operation.

> Case Study – Dance Champions Studio
>
> Ricardo owns the building from which he operates his dance studio decides to sell his business. However, Ricardo is not able to find a buyer that is able to purchase both the premises and business at the price he is asking. Ricardo decides to sell his dance studio to one of his existing instructors, Lisa, and leases out the premises to her. The next month he sells the premises to Rental Properties.
>
> As Ricardo has provided the business structure of his dance studio and the contractual right to occupy the particular premises, he has made a supply of a going concern to Lisa. He has also made a supply of a going concern to Rental Properties as he has provided a leasing enterprise, albeit short lived, and premises to be leased.

SUPPLY OF TWO SEPARATE ENTERPRISES BY TWO VENDORS TO ONE PURCHASER

It is common to have a business structure whereby one entity operates the business and a separate entity owns the land and buildings. When the two entities sell their enterprises to one purchaser and the contracts are interdependent, each supply must be considered separately.

> Case Study – Happy Motel
>
> Freddie operates a motel business, but leases the premises of Happy Motel from Wilma. Stone Happy wants to acquire both the business and the premises. The successful completion of each contract is subject to the completion of the other contract, **and both settlements will take place at the same time**.
>
> As Wilma is conducting a leasing enterprise, she may make a GST-free supply to Stone Happy, provided that the premises are supplied with the lease intact. Freddie may also make a GST-free supply to Stone Happy by selling the goodwill, plant and equipment, together with forward bookings etc, provided that he also assigns the lease of the premises to Stone Happy.

The ATO have now explicitly confirmed that in this fact scenario both settlements may occur simultaneously.* Prior to the new ruling, many commentators have been of the view that the two transactions should settle on different days.

Going concerns & partnerships

The application of this area of law to partnership will vary depending on the particular facts & circumstances of each supply in question, however the following should be noted:

- The mere admittance of a new partner to an existing partnership will not be a supply of a going concern as the general law provides that the new partner has only been supplied with a fractional interest in the assets of the partnership, not with all of the things that are necessary for the continued operation of an enterprise;
- Where the partnership entity sells its enterprise the supply will be GST-free if the going concern tests are met;
- Where a sole trader vends an enterprise into a partnership and then operates the whole enterprise via the partnership, the supply can be the supply of a going concern if the other tests are met; and
- Where a sole trader makes a supply of an enterprise to an existing partnership of which that person is already a partner, the supply will be the supply of a going concern if the other tests are met.[4]

Going concerns & companies

Where an entity that conducts an enterprise is a company, and that company supplies all the things necessary for continued operation of the enterprise, it will be a GST-free supply. However, when sale of the business is effected by selling the shares in the company, this will not satisfy the requirements of s 38-325. In this case the vendor of the shares does not conduct the enterprise. Therefore the supply of shares will be an input taxed financial supply.

Mortgagee sales

Under certain circumstances, such as at law or by virtue of the security documents, a creditor may be acting as agent for a debtor, and may sell the debtor's enterprise in order to repay monies owed by the debtor. If all the subdiv 38-J tests are met, this can be the supply of a going concern. However, if the creditor is not acting as an agent, div 105 will apply. For example, if a creditor forecloses on the assets of the enterprise.

Section 105(1) provides that the supply by a creditor will be a taxable supply if it would have been a taxable supply had it been made by the debtor. However, it will not be a taxable supply, pursuant to s 105-5(3), if either:

- The debtor has given the creditor a notice in writing that the supply would not be a taxable supply if the debtor were to make it, stating fully any supporting reasons; or
- The creditor believes on the basis of reasonable information that the supply would not be a taxable supply if the debtor were to make it.

CONCLUSION

In conclusion, GSTR 2002/5 signals significant changes in the ATO's view of when a supply of a going concern will be GST-free. This new ruling is a welcome response to the concerns voiced by industry groups and it marks a significant step towards reconciling the ATO's position with commercial reality. We hope that the tax rulings will continue to address the practical real life issues that practitioners confront. ◆

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Reference Notes

1 *All references are to A New Tax System (Goods and Services Tax) Act 1999 ("GST Act").*
2 *Paragraph 58 of GSTR 2002/5.*
3 *Paragraph 72 of GSTR 2002/5 expands on this issue.*
4 *Refer to paragraphs 190 – 194 of GSTR 2002/5*
* *Paragraph 139 of GSTR 2002/5*