DLA PIPER

22 OCTOBER 2013

GST & REAL PROPERTY LEASES – IMPLICATIONS OF THE MBI CASE

TAX UPDATE

The Full Federal Court recently handed down its decision in *MBI Properties Pty Limited v Commissioner of Taxation* [2013] FCAFC 112 (**"MBI Case"**).

The decision supports the view that neither the vendor or purchaser of a tenanted property (a reversionary interest) makes a new or continuing supply to the tenant following the sale of the property. This may have significant GST implications in relation to both tenanted residential premises (the lease of which is input taxed) and tenanted commercial premises (the lease of which is generally a taxable supply and subject to GST).

DECISION SUMMARY

The case was concerned with whether MBI Properties Pty Ltd (**"MBI"**) had an *"increasing adjustment"* under Division 135 of the *A New Tax System (Goods and Services Tax) Act 1999* (**"GST Act"**). The adjustment potentially arose as a consequence of MBI having purchased three tenanted residential apartments on a GST–free basis as the supply of a *"going concern"*.

The Full Court unanimously found in favour of MBI and held that a Division 135 adjustment did not arise. This was on the basis that:

(a) neither MBI, nor the previous owner of the apartments, made any new or continuing supplies to the tenant following completion of the apartment sales; and

(b) Division 135 only applies to supplies that are intended to be made by MBI itself – the Division does not apply in relation to supplies are intended to be made by other parties (such as the previous owner of the apartments).

Justice Edmonds delivered the leading judgement, with which Farrell and Davies JJ agreed.

The decision has important implications regarding the interpretation and application of the provisions in Division 135 of the GST Act. However, in this publication we have focussed on the potential implications of this decision for parties engaged in real property leasing transactions.

BACKGROUND

The facts can be summarised as follows:

- In August 2006, South Steyne Hotel Pty Ltd (**"South Steyne"**) strata subdivided the Sebel Manly Beach Hotel, creating 83 separate apartment lots and one Management Lot.
- South Steyne leased each of the 83 apartments to Mirvac Management Pty Ltd (**"MML"**), under 83 separate lease agreements. Each lease obliged MML to operate a scheme whereby all of the apartments were used together as part of a serviced apartment business.
- Between September 2006 and October 2007, South Steyne sold 15 of the apartments to investors, including three which were sold to MBI. MBI paid a total price of $2.15 million for the three apartments.
- Each of the investors that acquired the 15 apartments, including MBI, elected to participate in a *"Management Rights Scheme"*, which mirrored the scheme provided for under the leases.
- Following the earlier South Steyne Case (discussed below), the Commissioner issued MBI with a GST assessment for the 1 October 2007 to 31 December 2007 tax period (**"Assessment"**). The Assessment included an *"increasing adjustment"* of $215,000 (being 10% of the purchase price paid to acquire the three apartments).
- MBI objected to the Assessment in March 2012. The Commissioner disallowed the objection in full in April 2012.
- MBI applied to the Federal Court to appeal the Commissioner's objection decision. Justice Griffiths dismissed that application and found in favour of the Commissioner in February 2013.
- MBI appealed Griffiths J's decision to the Full Federal Court. The Full Court unanimously found in favour of MBI. The Full Court ordered that both Griffiths J's appeal decision and the Commissioner's objection decision be set aside, and that MBI's original objection to the Assessment be allowed in full.

EARLIER DECISIONS IN THE SOUTH STEYNE CASE

Several parties, including South Steyne and MBI, had applied to the Federal Court in January 2009 seeking declaratory orders regarding the GST treatment of the lease and sale transactions outlined in the Background section above (see *South Steyne Hotel Pty Ltd v Federal Commissioner of Taxation* (2009) 180 FCR 409) (**"South Steyne Case"**). The decisions of Stone J in the South Steyne Case were subsequently appealed to the Full Federal Court.

The GST treatment of the supplies was determined to be as follows:

- Justice Stone held that the lease of each of the 83 apartments by South Steyne to MML was an input taxed supply of residential premises (rather than a taxable supply of *"commercial residential premises"*). This conclusion was unanimously upheld by the Full Court.
- Justice Stone held that South Steyne's sale of the 15 apartments to investors were taxable supplies and subject to GST. The majority of the Full Court disagreed and held that the sales were GST–free as the supply of a going concern.
- Justice Stone also held that MBI's supplies in respect of the leases to MML, as a consequence of MBI's purchase of the reversionary interest in the apartments, were input taxed supplies. The Full Court unanimously held that there was no supply by MBI to MML following the apartment sales.

DIVISION 135 – INCREASING ADJUSTMENTS

Section 135–5(1) of the GST Act provides as follows:

"You have an increasing adjustment if:

> *(a) you are the recipient of a GST–free supply of a going concern, or supply that is GST–free under section 38–480; and*

(b) *you intend that some or all of the supplies made through the enterprise to which the supply relates will be supplies that are neither taxable supplies nor GST–free supplies."*

The Commissioner was of the view that an increasing adjustment arose for MBI following its purchase of the apartments. This was on the basis that the apartments, which had been acquired GST-free as the supply of a going concern, were intended to be used to make input taxed supplies to MML.

Given the Full Federal Court had unanimously held in the South Steyne Case that MBI does not itself make any supplies to MML, it was necessary for the Commissioner to establish that:

(a) South Steyne (as the previous owner and grantor of the leases) was treated as continuing to make an input taxed supply to MML following the sale of the apartments; and

(b) for the purposes of section 135–5(1)(b) of the GST Act, a third party (such as South Steyne) could have the intention of making an input taxed supply through the acquired enterprise. That is, it is not necessary for the purchaser (ie MBI) to intend on making an input taxed supply.

The Commissioner was unsuccessful on both issues before the Full Federal Court.

WHAT SUPPLY IS MADE BY A LANDLORD TO A TENANT?

Justice Edmonds addressed the nature of the supply that is made by a landlord at paragraph 24 of the judgment where he stated:

"... The lease is the subject of the supply, not the 'supply'; the 'supply' is the grant of the lease: see s 9–10(2)(d) of the GST Act. The act of grant does not continue for the term of the lease; the 'supply' is complete on the lease coming into existence. The 'supply' constituted by the grant of the lease did not continue beyond the grant; the fact that the lease continued was solely a function of the terms of the grant, not a continuing supply by the grantor."

His Honour further stated at paragraph 29 of the judgement:

"In my view, the primary judge erred in concluding that, following the sale of the reversion from South Steyne to MBI, there was a continuing supply by South Steyne to MML; there was no continuing supply, merely a continuation of the lease, the subject of the supply made by South Steyne to MML by the grant."

The Commissioner had argued that an earlier Full Federal Court decision, *Westley Nominees Pty Ltd v Coles Supermarket Australia Pty Ltd* (2006) 152 FCR 461 (**"Westley Nominees Case"**), supported his view that South Steyne's supplies in connection with the leases to MML continued following the sale of the reversions. This argument was rejected by both Edmonds and Davies JJ on the basis that the Westley Nominees Case concerned transitional provisions in the *A New Tax System (Goods and Services Tax Transition) Act 1999*, rather than the provisions of the GST Act.

RELEVANCE OF DIVISION 156 – GST PAYMENT TIMING RULES RELATING TO LEASES

Division 156 of the GST Act contains *"special rules"* which deal with the timing of GST payments for supplies that are made on a *"periodic and progressive"* basis. Where the rules apply, GST payments can be spread out to match each periodic or progressive component of the supply.

In relation to leases, section 156–22 states:

"For the purposes of this Division, a supply or acquisition by way of lease, hire or similar arrangement is to be treated as a supply or acquisition that is made on a progressive or periodic basis, for the period of the lease, hire or arrangement."

The effect of this section is that where GST is payable in respect of a taxable lease, the GST payments should be spread out to match each corresponding lease period, rather than all of the GST being payable upfront at the time that the lease is granted. For example, GST is payable on a monthly basis if the rent and outgoings are invoiced and payable monthly.

Because the above section only applies to taxable leases, and is not relevant for residential leases which are input taxed, the Commissioner was not able to rely on this section in the MBI Case to

support the proposition that South Steyne made a continuing supply in respect of the leases to MML.

In any event, even if the relevant supplies had been taxable, it is arguable that Division 156 merely addresses GST timing issues, without going so far as to deem or treat a lease as being supplied on a periodic or progressive basis. This view may be supported by the opening words in section 156–22, which limit the operation of the section to the purposes of Division 156. If it was intended that section 156–22 should deem a lease to be treated as a periodic or progressive supply for all purposes of the GST Act (including for the purposes of the provisions dealing with *"supply"* concepts), such a limitation would not be necessary.

COMMISSIONER'S CURRENT POSITION IN RELATION TO COMMERCIAL PREMISES – GSTD 2012/2

Generally speaking, the lease of commercial premises is a taxable supply and subject to GST (assuming the landlord is GST registered, or required to be GST registered).

The Commissioner's view as set out in a GST Determination, GSTD 2012/2, is that following the sale of tenanted commercial premises:

(a) the purchaser is liable for GST in respect of the continuing lease, with the timing of the GST payments to be determined in accordance with Division 156; and

(b) the vendor is no longer liable for GST in respect of the continuing lease, where the vendor is no longer entitled to the rent or other consideration payable under the lease.

It is clear from GSTD 2012/2 that the Commissioner is of the view that there is a *"continuing supply of the leased commercial premises"* following the sale of such premises. This view is supported by reference to the Full Federal Court decisions in both the Westley Nominees and South Steyne Cases.

However, as outlined above, Edmonds J is clear in his decision in the MBI Case that there is no *"continuing supply"* in relation to a lease. Rather, the *"supply"* is the grant of the lease which does not continue for the term of the lease. In contrast, Edmonds J considers the continuing lease to be the subject of the supply (refer extracted paragraph 24 above).

On the basis that there is no continuing supply, it is arguable that the Commissioner's views in GSTD 2012/2 is incorrect and the purchaser does not have any GST liability in respect of a continuing lease following the purchase of a reversionary interest in a tenanted commercial premises. As discussed above, section 156–22 may not assist the Commissioner in respect of this issue, given that the section arguably only addresses GST payment timing issues (and not *"supply"* issues more broadly).

IMPLICATIONS FOR TENANTED COMMERCIAL PREMISES

It is presently unclear whether the Commissioner may apply to the High Court for special leave to appeal the decision in the MBI Case. The following comments assume that the decision is not appealed (or is not overturned on appeal).

Issues for vendors

It is unclear whether an entity that grants a lease will continue to be liable for GST in respect of that lease after the property has been sold. On the one hand, it is clear that the Full Court considers the grantor to be the only party that makes a taxable supply (being the grant) in respect of a lease. However, it would also seem to be the Full Court's view that the supply made by the grant *"did not survive the sale of the reversion"* (refer paragraph 25 of Edmond J's decision).

Some vendors may be concerned that they could potentially have an ongoing GST liability in respect of the grant of the lease for the whole lease period, even after a property has been sold. To address this risk, vendors may want to seek indemnities from purchasers. It should be noted that vendors may also have protection if they can demonstrate reliance on the Commissioner's views in GSTD 2012/2, which clearly state that a vendor is not liable for GST in respect of a lease following the sale of a reversion (where the vendor ceases to be entitled to rent or other consideration).

Issues for purchasers

Purchasers that acquire a tenanted commercial premises will need to consider whether they are liable for GST in respect of any leases (that were on foot at the time of sale) following completion of the

sale. This will particularly be the case if tenants begin to demand refunds for GST amounts that may have been paid under a lease.

As a practical matter, a tenant will likely only seek a refund for GST amounts that have been paid under a lease if the tenant is not entitled to full input tax credits for its acquisition of the lease. This will generally only be the case for tenants are not GST registered, or for tenants that make input taxed supplies (such as banks or other financial institutions).

Purchasers may also need to consider whether they may be entitled to refunds of GST that they have remitted in prior tax periods in respect of continuing leases following the acquisition of a reversionary interest. There are time limits that apply to restrict such refunds. The provisions in section 105–65 in Schedule 1 of the *Taxation Administration Act 1953* (**"section 105–65"**) would also need to be considered. Those provisions provide the Commissioner with the discretion to not pay GST refunds in certain circumstances.

IMPLICATIONS FOR RESIDENTIAL PREMISES

The following comments again assume that the decision in the MBI Case is not appealed (or is not overturned on appeal).

Issues for vendors

Vendors that are marketing new residential premises for sale to investors may want to consider whether such sales can be structured as GST–free going concern sales (if this will provide a pricing benefit to the vendor). This approach is likely only going to be of interest to sophisticated investors that understand the risks and who are purchasing one or more expensive properties.

Previously there has been little incentive to structure sales of residential premises as a going concern, given the likelihood that the purchaser would have a Division 135 increasing adjustment. While there has always been a stamp duty benefit, it is generally seen as immaterial and not worth the associated costs.

Issues for purchasers

Purchasers that have previously acquired a residential premises as a going concern, and then included a Division 135 adjustment in a subsequent GST return, may now be entitled to a refund in respect of that adjustment. There are time limits that can restrict entitlements to refunds (generally being a four year time limit). Affected purchasers should consider whether they may need to be taking any steps now to preserve their refund entitlements (subject to any appeals or legislative amendments following the MBI Case).

Purchasers that are contemplating acquiring a new residential premises as a going concern following the decision in the MBI Case should exercise caution until it is clear whether the decision will be appealed, or whether the Government may look to introduce amending legislation. It may be advisable for purchasers to base their purchasing decision on the assumption that a Division 135 adjustment will be payable if they proceed with a going concern purchase.

CONTACT US

We would be pleased to assist if you have any queries regarding the GST issues discussed in this publication.

MORE INFORMATION

For more information, please contact:

Matthew Cridland
Partner
T 02 9286 8202
matthew.cridland@dlapiper.com

Contact your nearest DLA Piper office:

BRISBANE

Level 29, Waterfront Place
1 Eagle Street
Brisbane QLD 4000
T +61 7 3246 4000
F +61 7 3229 4077
brisbane@dlapiper.com

CANBERRA

Level 3, 55 Wentworth Avenue
Kingston ACT 2604
T +61 2 6201 8787
F +61 2 6230 7848
canberra@dlapiper.com

MELBOURNE

Level 21, 140 William Street
Melbourne VIC 3000
T +61 3 9274 5000
F +61 3 9274 5111
melbourne@dlapiper.com

PERTH

Level 31, Central Park
152–158 St Georges Terrace
Perth WA 6000
T +61 8 6467 6000
F +61 8 6467 6001
perth@dlapiper.com

SYDNEY

Level 38, 201 Elizabeth Street
Sydney NSW 2000
T +61 2 9286 8000
F +61 2 9286 4144
sydney@dlapiper.com

www.dlapiper.com

DLA Piper is a global law firm operating through various separate and distinct legal entities.

For further information, please refer to www.dlapiper.com

Copyright © 2012 DLA Piper. All rights reserved.

This publication is intended as a first point of reference and should not be relied on as a substitute for professional advice. Specialist legal advice should always be sought in relation to any particular circumstances and no liability will be accepted for any losses incurred by those relying solely on this publication.