GST REFORM: IMPLICATIONS FOR THE REAL ESTATE SECTOR

BACKGROUND TO AUSTRALIAN GST

Goods and Services Tax ("**GST**") commenced in Australia on 1 July 2000. While there have been some amendments since its introduction, the tax has remained largely unchanged for the past 15 years.

In recent weeks there has been increasing press reports on potential GST reforms, including possible GST rate and / or GST base changes.

The Treasurer, Joe Hockey, initiated a debate around Australian tax reform through the release of a Tax Discussion Paper ("**Discussion Paper**") on 30 March 2015. The Government invited submissions in response to the Discussion Paper, including in respect of GST.

The Prime Minister, Tony Abbott, has maintained that the Government will not introduce GST reforms during the current electoral term (due to expire in late 2016). The Government has also indicated that any GST reforms would need the universal support of all eight state and territory Governments.

According to the Government's Discussion Paper, GST raised $56 Billion, or 16% of total Australian Government Tax Revenue, in 2013 -14.

GST RATE INCREASE

Since introduction, GST has always applied at a rate of 10%.

The NSW Premier, Mike Baird, recently stated that he supports increasing the GST rate to 15%. A number of submissions lodged in response to the Government's Discussion Paper have also called for an increase in the rate (generally to either 12.5% or 15%).

As at 1 January 2015, the average VAT (GST) rate amongst OECD countries was 19.2%. The current GST rate in New Zealand is 15%. Most countries within the European Union, including the United Kingdom, have a rate of 20% or higher.

GST BASE INCREASE

GST was intended to be a "broad based" consumption tax. According the Discussion Paper, at its peak (in 2005/6), GST applied to 56% of total consumption in Australia. That coverage dropped to 47% in 2012.

Presently basic food, health, education, residential rent and the sale of existing (i.e. second hand) residential premises are all exempt from GST.

Further, digital content and services purchased from non-residents outside Australia is not presently caught within the GST net. However, the Government announced as a part of the Federal Budget in May 2015 that GST will apply to intangible supplies made by non-residents to Australian consumers from 1 July 2017. This reform has been cited in the media as the "Netflix Tax" and is intended to capture all intangible supplies (including digital content).

Goods purchased from non-resident suppliers (usually online) and imported into Australia with a value of less than $1,000 are presently exempt from GST. However, on 21 August 2015, the Treasurer announced that this threshold will be abolished, and related reforms introduced, again with effect from 1 July 2017.

IMPACT OF A GST RATE INCREASE ON THE REAL ESTATE SECTOR

For the Australian real estate sector, the impact of a GST rate increase will vary depending on the type of premises involved (as outlined further below).

The three areas of greatest impact will be where:

(a) **A supplier is liable for GST and cannot change its prices to take account of a GST rate increase (resulting in lower margins / returns).**

Example: If a residential developer is selling a "new residential premises" that is subject to GST, and the developer cannot increase the price of the premises due to market conditions, the developer would need to bear the cost of any GST rate increase.

(b) **A supplier is not entitled to full input tax credits (GST credits) and will incur higher "GST leakage" on external costs if the GST rate is increased.**

Example: A retirement village operator who leases an independent living unit to a resident will not be entitled to input tax credits for GST incurred on costs associated with the lease. For new villages, this may include land acquisition and development costs. The irrecoverable GST cost, often referred to as "GST leakage", will increase if the rate is increased.

(c) **The consideration for a supply is calculated by reference to income or expenses which may be negatively impacted by a GST rate increase.**

Example: Retail sales may decline if there is a GST rate increase. This could in turn impact turnover rents for retail premises.

The tables below summarise the position for the sale or lease of different types of premises.

Critically, it should be noted that the tables below do ***not*** take into account the potential impact of the reduction or abolition of other property taxes (such as stamp duty) which may occur if the GST rate is increased.

For example, if stamp duty is abolished on the sale of residential premises, purchasers would have more money to spend and may be prepared to pay higher prices. This may allow developers of new residential premises to increase prices so as to offset the impact of a GST rate increase.

Further, the tables below do not take into account any transitional relief or other grandfathering arrangements that may apply to existing purchase options, sale contracts or development projects which are in place when the rate is increased.

In relation to Property Sales, the table below also indicates whether New South Wales stamp duty and New South Wales land tax currently apply.

A. PROPERTY SALES

Type of Premises	GST Treatment	Impact of GST Rate Increase	NSW Duty Applicable on Purchase?	NSW Land Tax Applicable?
New Residential Premises	Taxable - subject to GST (see comments further below regarding the margin scheme)	More GST payable on sale. Purchaser cannot claim credit. If purchasers won't pay a higher price, this erodes the vendor's margins on sale.	Yes - some concessions for first home buyers.	Yes, subject to principal place of residence exemption.
Existing (second hand) residential premises	Input taxed - not subject to GST	No impact on sale. However, parties will not be entitled to input tax credits for GST incurred on sale and purchase costs (which will increase if there is a GST rate increase).	Yes.	Yes, subject to principal place of residence exemption.
Farm Land to be used for farming	GST-free - not subject to GST	No impact on sale. If GST registered, the parties should also be entitled to full input tax credits for GST incurred on sale and purchase costs.	Yes.	No, if primary production exemption available.
Vacant commercial premises	Taxable - subject to GST	More GST payable on sale. However, purchaser may be entitled to recover the GST as a full credit, meaning zero net GST impact. Note that not all GST registered purchasers are entitled to full credits.	Yes.	Yes.

Type of Premises	GST Treatment	Impact of GST Rate Increase	NSW Duty Applicable on Purchase?	NSW Land Tax Applicable?
Tenanted commercial premises	GST-free as sale of going concern. Not subject to GST.	No impact on sale. If GST registered, the parties may be entitled to full input tax credits for GST incurred on sale and purchase costs.	Yes.	Yes.
Commercial residential premises (i.e. hotels, motels, boarding houses, hostels and some student accommodation).	Taxable or GST-free (depending on whether sold as a going concern).	No impact if purchasers entitled to full input tax credits. If purchasers are not entitled to full input tax credits, and won't pay a higher price, this may erode the vendor's margins on sale.	Yes.	Yes.
Independent Living Units in Retirement Village	Taxable if new residential premises (see above). Input taxed if existing residential premises (see above).	See impacts for new and existing residential premises above.	Yes (on sale of village or sale of freehold in ILU).	No.
Social Housing	Taxable if new residential premises (see above). Input taxed if existing residential premises (see above).	See impacts for new and existing residential premises above.	Yes (potential exemptions if sold to a charity or Government entity).	Some exemptions for low cost accommodation.

B. PROPERTY LEASING

Type of Premises	GST Treatment	Impact of GST Rate Increase
Residential Premises (both new and existing)	Input taxed - not subject to GST	Entities that build new residential premises (including retirement villages) for lease will not be entitled to claim input tax credits for GST paid on land acquisition or construction costs. This may increase development costs if the GST rate increases.
Farm Land	Taxable - subject to GST	GST registered farmers should be entitled to claim input tax credits for any GST paid, meaning zero net GST impact.
Commercial premises	Taxable - subject to GST	GST registered business should be entitled to input tax credits, meaning some tenants will be little impacted if additional GST costs are passed on under a lease. Tenants that make input taxed supplies will be more resistant to having GST increases passed on in full. Lessors that cannot pass on full GST costs will have lower net rentals if the rate is increased. A GST rate increase, or broadening of the GST base, may also negatively impact retail sales. This could in turn negatively impact "turnover rents" for retail premises.

Type of Premises	GST Treatment	Impact of GST Rate Increase
Commercial residential premises (i.e. hotels, motels, boarding houses, hostels and some student accommodation).	Short term stays are taxable - subject to GST. Long-term stays (28 days or more) are, at the election of the operator: - Input taxed (not subject to GST). - Taxable at a concessional rate of 5.5%.	A rate increase would likely see the price for short term stays increase. Some business customers would be able to recover the additional cost as a credit. GST would not apply if operators elect to treat long-term stays as input taxed. However, operators will not be entitled to credits for GST incurred on costs (which will increase if the rate goes up). For operators who elect to treat long-term stays as taxable supplies, it is likely that the concessional rate of 5.5% would be increased correspondingly if the full rate is increased to 12.5% or 15%.
Independent Living Units in Retirement Villages	If the operator is not a charity, the lease or license of an ILU will be input taxed. See input taxed supplies of "Residential Premises" above. May be GST-free if leased by a charity and concessional requirements are met.	If the operator is not a charity, see impact for Residential Premises above. There should be little to impact where the lease supplies are GST-free.
Social Housing	Input taxed. May be GST-free if leased by a charity and concessional requirements are met.	See impact for Residential Premises above. There should be little to impact where the lease supplies are GST-free.

RETIREMENT VILLAGES (OPERATED BY "FOR PROFIT" ENTITIES)

Generally speaking, independent living units ("**ILUs**") in retirement villages are treated in the same manner as other residential premises for GST purposes. If the village operator is not a charity (i.e. is a "for profit" operator), the lease or license of accommodation within the village should be an input taxed supply (and not subject to GST).

If a retirement village operator (which is not a charity) acquires land and constructs a new village, with the intention of holding the village as a long-term asset, the operator will not be entitled to full input tax credits for GST incurred on its development acquisitions (i.e. the land acquisition and construction costs). This irrecoverable GST cost can potentially be a "deal killer" that prevents a new village from being developed.

Similarly, full input tax credits are not available for GST incurred in respect of on-going repair and maintenance costs, and many other operational costs, relating to ILUs.

If the same retirement village operator instead undertakes the development with the intention of selling the new village (rather than holding as a long-term asset), input tax credits would be available for most of the GST incurred on the development acquisitions. However, as the sale of the village would be a taxable supply and subject to GST, and most buyers would not be entitled to credits, there may be few interested buyers. An exception may be a charity which can take advantage of concessional GST rules for retirement villages operated by charities (and hence may be open to acquiring a newly developed retirement village).

Accommodation supplied in villages operated by a charity is GST-free and full input tax credits are available for GST incurred on associated costs (including land acquisition and development costs, GST paid on the acquisition of a newly developed village and for GST incurred in relation to on-going repair / maintenance and other operating costs).

The above GST issues would be exacerbated in the "for profit" retirement village sector if the GST rate is increased.

THE MARGIN SCHEME

Where available, the margin scheme reduces the GST payable on a sale of real property. It is generally only used for the sale of new residential premises.

Under the margin scheme, GST is calculated based on the "margin" on the sale (rather than the total purchase price).

In high level terms, and subject to a number of exceptions, the margin is generally the difference between the developer's selling price and either:

(a) the value of the land as at 1 July 2000; or

(b) the price the developer paid to acquire the property.

Again in high level terms, the margin scheme is only available if either:

(a) the land was acquired before 1 July 2000; or

(b) the land was acquired through an approved method for margin scheme purposes.

If the GST rate is increased, the value of the margin scheme concession would similarly increase (assuming it continues to be available). Where the margin scheme is available, this may partially offset some of the impact of a GST rate rise for developers of new residential premises.

PROPERTY FUNDS

A GST rate rise would also have implications for property funds (Head Funds) that invest in other property funds that own real property assets (i.e. a Head Fund that only invests in securities, such as units or shares and exceeds the "financial acquisitions threshold" ("**FAT**")).

The issue is that a Head Fund will only make financial supplies for GST purposes, through issuing units / shares to investors and acquiring units / shares in sub-funds. While GST doesn't apply to such transactions, full input tax credits (GST credits) are not available for GST incurred on costs associated with these financial supplies.

For example, full input tax credits are not available for GST incurred on RE fees, investment management fees, audit costs, legal, accounting and other professional services.

Partial credits may be available in some instances, but there will still be "GST leakage".

Such GST leakage will increase if the GST rate is increased.

Property funds that directly own and lease commercial premises do not generally exceed the FAT, and hence are less likely to be impacted by additional GST leakage as a result of a GST rate increase.

INDUSTRIAL PROPERTY - A FILLIP FROM THE ABOLITION OF THE LOW VALUE IMPORT THRESHOLD?

Goods valued at less than $1,000, and imported via parcel delivery / mail, are exempt from GST and duty. The same goods purchased from a retailer in Australia are subject to 10% GST (and potentially duty, depending on the specific goods). The threshold applies to each separate importation.

To better compete with non-resident suppliers, some Australian retailers have established warehouses in various countries throughout Asia. Those retailers then encourage customers to order online and ship their goods directly to Australian customers from Asia, so that each sale for less than $1,000 is exempt from GST and duty.

With the Government having announced that the low value import threshold will be abolished, with effect from 1 July 2017, query whether this GST reform may also act as a fillip for the industrial property sector.

If the GST pricing benefit is eliminated, Australian based businesses may re-evaluate the benefit of maintaining warehouses overseas and the cost of shipping from outside Australia (even if they continue to maintain their online store presence). Other commercial considerations will obviously be relevant to any decision on whether to warehouse more stock in Australia.

MORE INFORMATION

For more information, please contact:

Matthew Cridland
Partner
T +61 2 9286 8202
Matthew.Cridland@dlapiper.com

www.dlapiper.com

1202798654 KPE 0915