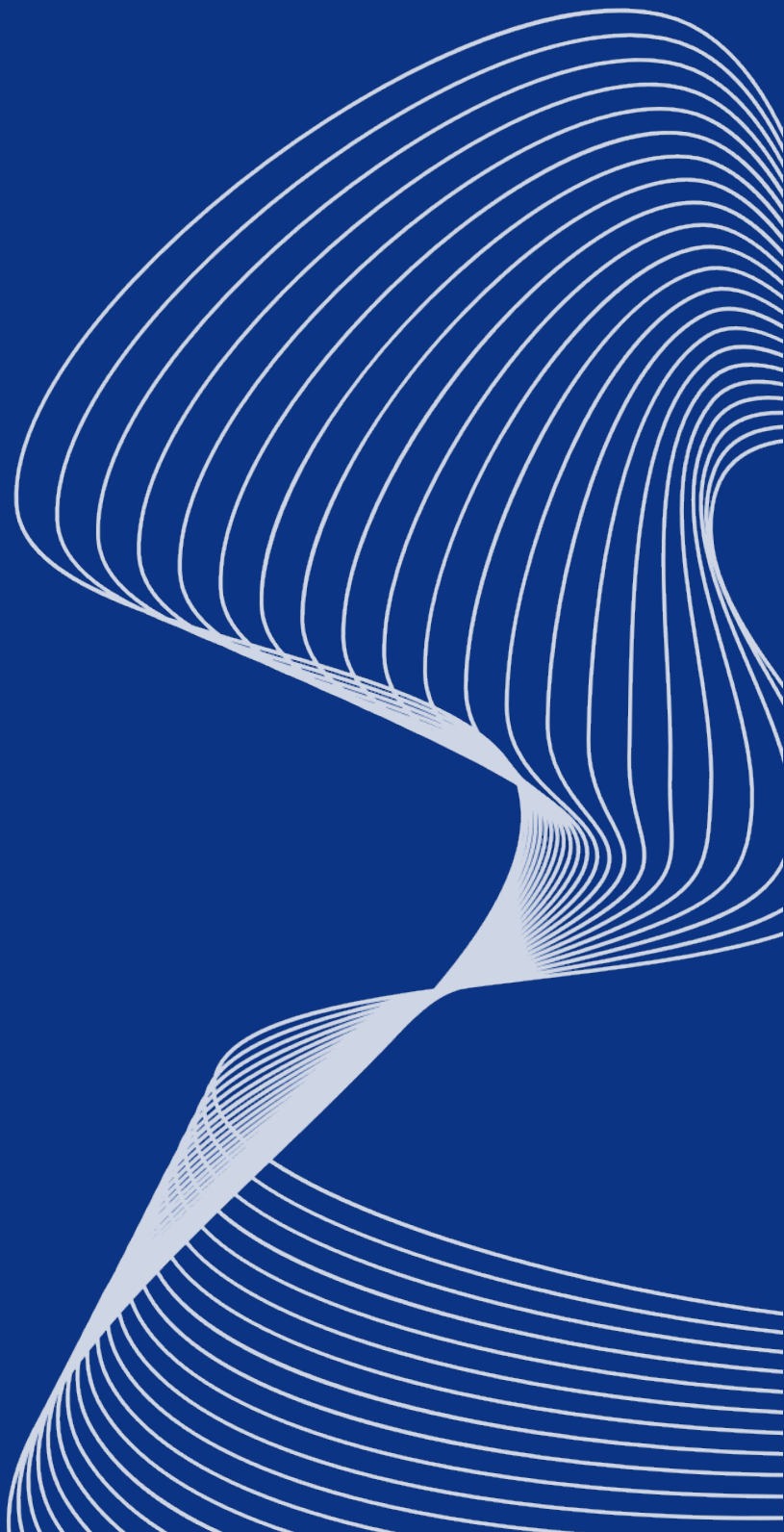
GST and Real Property

THE ROAD TO HELL IS PAVED WITH GOOD INTENTIONS



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1. Introduction[1]

The application of GST to real property has been the subject of much conjecture and dispute since the introduction of the tax. A combination of factors including the high value of supplies of real property, complexity surrounding the numerous ways property is held and the fact that you do not have to be a property developer to have GST property issues, have made property a hot GST topic. Also added to this mix is the fact that real property in Australia is subject to GST where other jurisdictions have specifically excluded land from the GST or VAT net.

Fundamentally, the inclusion of land in the Australian GST system when considered in the context of a value added or consumption tax has been the subject of some criticism. Such criticisms focus on the point that property cannot be classified as being 'consumed', but rather, (in most cases) an appreciating asset and therefore perhaps should fall outside of the scope of GST Law.

The continuation of GST property related issues featuring heavily in the Commissioner of Taxation's Annual Compliance Programs, suggests it is an area that still troubles the Commissioner and taxpayers alike. One such GST property issue is ensuring its correct application to transactions involving real property and importantly, how this may impact on the entity's entitlement to input tax credits (or a portion thereof). Understanding how to navigate the relevant provisions to achieve compliance, ensures their application does not negatively impact the cash flow or overall net GST position of either the vendor or the purchaser.

The intention of a landowner or supplier can be an extremely important aspect of determining the tax treatment of a transaction or an entity's entitlement to an input tax credit. These intentions can also be quite difficult to support when required and they can also change over time.

To comply with the GST Act[2], practitioners may find themselves having to ask a client what their intention is for a property at a particular point of time. This paper will take a closer look at the intention surrounding:

- When is the purchase of a commercial property a going concern and subsequently a GST-free supply?
- What intention does the purchase of farmland fall under the GST-free farmland exemption?
- Is the test for residential premises determined by intended use or the characteristics of the property? *(Sunchen Pty Ltd v Commissioner of Taxation* [2010] FCAFC 138*)*
- Does the change of intention of use of a new residential property affect the adjustment period?
- What GST implications exist if a property's intended use is of a mixed nature?

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[2] Unless otherwise stated, all legislative references are to the *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act).

- General tips to support a property's intended use and keep the property GST compliant.

2. Supply of a Going Concern

The general GST rules provide that everything is taxable unless it is GST-free or input taxed. The supply of an enterprise, or part of an enterprise, that is the supply of a going concern[3] can be GST-free where certain conditions are met. These include:

a) The supply is for consideration.

b) The recipient is registered or required to be registered.

c) The supplier and the recipient have agreed in writing that the supply is of a going concern.[4]

To meet the definition of being the 'supply of a going concern', there are requirements placed on the supplier about the thing being supplied, namely:

- The supplier supplies to the recipient all of the things that are necessary for the continued operation of an enterprise; and

- The supplier carries on, or will carry on, the enterprise until the day of the supply.[5]

If all of the above are met, then the supply of something that may have otherwise been taxable, may be supplied GST-free.

Intention of using a going concern for commercial leasing

The sale of a property alone isn't regarded as a going concern, however where the property is supplied with other things, it may meet the definition. These things include:

- the business property, when sold together with the assets and operating structure of the business.

- a fully tenanted building, where the property and all leases, agreements and covenants are included in the sale.

- a partially tenanted building, where the vacant part of the building is either actively marketed for lease or undergoing repairs or refurbishment, and all of the other leases, agreements and covenants are included in the sale.[6]

A common application of the going concern provisions is to the supply of a leasing enterprise of commercial premises. While the supply of a fully tenanted commercial building as part of a GST-free going concern is mostly uncontroversial, there are potential issues to navigate surrounding when that enterprise commences (and therefore is operating) as well as what happened when a building is not fully tenanted when sold.

[3] Subdivision 38-J.
[4] Section 38-325 (1).
[5] Section 38-325 (2).
[6] GSTR 2002/5.

When does a commercial leasing enterprise commence?

The going concern provisions require a supplier to both 'carry on' and operate the enterprise being supplied for that supply to be GST-free. The difference between the two is probably best explained by the Commissioner at paragraph 150 of Goods and Services Tax Ruling GSTR 2005/5, which states:

> *150..... Where an enterprise engaged in an activity ceases to carry on that activity and the assets are in the course of being sold off, the enterprise is being 'carried on', but is not operating.*

It is here, at an early stage of a commercial leasing enterprise, that intention is overridden by action in the context of the going concern provisions. Where an entity builds a commercial building with the intention of leasing, it is not enough to hold that intention and achieve GST-free status of any sale unless the activity of leasing has commenced. The Commissioner at paragraph 151 of GSTR 2005/5 states

> *151. The activity of leasing a building which has previously been leased to a tenant remains an 'enterprise' of leasing for the purposes of section 9-20 during the period of temporary vacancy when a new tenant is being actively sought by the building owner. However, where a building has not previously been leased to a tenant, but is being actively marketed, an 'enterprise of leasing' is not operating until the activity of leasing actually commences. The activity of leasing commences when at least one tenant enters into an agreement to lease or occupies the building.*

As outlined in the Commissioner's view, the intention to lease is not enough to achieve going concern treatment unless there is also the activity of leasing present.

Commercial building not fully tenanted

The question of intention also becomes relevant for the supplier of a partly tenanted building. There, it is a requirement for the supplier to continue or intend that the property will be held out for lease despite the fact a tenant is not currently in place for the relevant components of the property. In this scenario, it is not good enough those untenanted parts are also supplied with other parts subject to a lease for the entire building to be supplied as part of a going concern.

The Commissioner takes the view the non-tenanted areas either need to be the subject of repair or refurbishment, or need to be continued to be actively marketed for lease, for them to form part of a going concern with other, tenanted parts of the building. Paragraph 153 and 154 of GSTR 2005/5 outline his position:

> *153. In the course of conducting an enterprise of leasing a building, certain floors may be unavailable for lease temporarily while repairs, refurbishments or other activities requiring vacancy take place. The requirement that vacant floors be actively marketed will not apply to those floors for the period during which the activities are taking place.*
>
> *154. Some areas or floors may not be available for lease but may still be part of the enterprise of leasing the building. The areas may be used for storage of cleaning equipment, as offices for the building manager or for some other purpose relevant to the enterprise of leasing. Where the supplier can demonstrate that all of the floor space in the building is part of an enterprise of leasing on the day of the supply, the supply of the whole building together with all of the other things necessary for the continuation of the leasing enterprise may be a 'supply of a going concern'.*

Evidencing this intention is best achieved through being able to demonstrate the active marketing, or repair or refurbishment work is actually being carried out. Things like marketing materials, engagement

letters with sales agents, advertising invoices, building contracts, construction invoices and other documents would all be useful evidence to prove the requisite intention exists if required.

Change of use by the purchaser of a going concern

Another way that intention is important in relation to a going concern, is what the purchaser intends to do after the sale of the property. If a purchaser intends to use a property for a reason other than to make taxable sales or GST-free sales in the continued operation of the enterprise, then an adjustment may be triggered under Division 135.

In form, Division 135 provides two straightforward operations being either initial or later adjustments. However, in substance, the Division contains a few complexities in both its interpretation and application.

Initial adjustments

Subsection 135-5(1) sets out the relevant "use" test in relation to certain acquisitions and it contains two limbs, both of which need to be satisfied in order for there to be an initial increasing adjustment. It states:

> *(1) You have an increasing adjustment if:*
>
> *(a) you are the recipient of a supply of a going concern, or a 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 first limb of subsection 135-5(1) exhaustively identifies the supplies which are relevant to the reverse charge consideration which includes, a supply of a going concern and the GST-free supply of farmland. The second limb of subsection 135-5(1) stipulates that the entity has an intention that some or all of the supplies they make through the enterprise to which the supply relates are neither taxable nor GST-free. The provision does not specify when the intention needs to be determined however, the fact you must have been "the recipient of a supply of a going concern, or a supply that is GST-free under section 38-480" suggests that the relevant timing is after you have made the relevant acquisition and not before.

A critical question to the second limb is the identification of the "enterprise to which the supply relates" and may be easily answered if the going concern acquired can be easily distinguished from the remainder of the recipient's enterprise. Where the recipient acquires a number of going concerns or melds them into existing enterprises and in which case, the correct answer becomes far more problematic.

The calculation of the 'initial' increasing adjustment is set out in subsection 135-5(2), which states:

> *(2) The amount of the increasing adjustment is as follows:*
>
> *1/10 x Supply price x Proportion of non-creditable use*
>
> *where:*
>
> ***proportion of non-creditable** use is the proportion of all the supplies made through the enterprise that you intend will be supplies that are neither taxable supplies nor GST-free*

*supplies, expressed as a percentage worked out on the basis of the *prices of those supplies.*

***supply price** means the price of the supply in relation to which the increasing adjustment arises.*

Of note is that the measured "proportion of non-creditable use" required in subsection 135- 5(2) differs from that of "creditable purpose" contained within section 11-5 which does not require a “proportion” on the basis of price to be determined. Such a difference potentially limits the scope of apportionment available under Division 135 in that other ‘reasonable’ methods of apportionment cannot be used.

Later adjustments

Subsection 135-10 sets out the relevant later adjustment to be made, it states:

(1) If you are the recipient of a supply of a going concern, or a supply that is GST-free under section 38-480, Division 129 (which is about changes in the extent of creditable purpose) applies to that acquisition, in relation to:

(a) the proportion of all the supplies made through the enterprise that you intend will be supplies that are neither taxable supplies nor GST-free supplies; and

(b) the proportion of all the supplies made through the enterprise that are supplies that are neither taxable supplies nor GST-free supplies;

in the same way as that Division applies:

(c) in relation to the extent to which you made an acquisition for a creditable purpose; and

(d) in relation to the extent to which a thing acquired is applied for a creditable purpose.

(2) For the purpose of applying Division 129, the proportions referred to in paragraphs (1)(a) and (b) are to be expressed as percentages worked out on the basis of the prices of the supplies in question.

(3) This section applies in relation to any supply of a going concern, or a supply that is GST-free under section 38-480, whether or not it is a supply in respect of which you have had an increasing adjustment under section 135-5.

The effect of section 135-10 is to capture subsequent events which either alter the calculation made under section 135-5, or if present at the time of the acquisition, would have required an initial increasing adjustment to be made. Section 135-10 achieves this by providing a statutory modification to the operation of Division 129 which requires the relevant calculation to be altered where appropriate. As with the calculation required under section 135-5, the difficulty becomes identifying the "actual application of the thing" as a percentage, especially where the going concern acquired has lost its original identity (see below for further discussion on this issue).

Identifying what needs to be included

In applying Division 135, the crucial question remains the scope of a supply “made through the enterprise”. The singular wording of “enterprise” suggests that the requisite calculation is made solely

by reference to supplies intended to be made through the acquired enterprise and not through any other existing enterprise (or enterprises) carried on by the recipient. However, the Commissioner takes the view that such wording should be read as "enterprises" which therefore opens up the calculation to the broader activities undertaken by the recipient. The Commissioner's view is outlined at 6.2.14 of the Primary Production Industry partnership issues register, which states:

> *The words the enterprise in Division 135 of the GST Act should be read as the enterprises. The term is capable of including an enterprise or enterprises other than a farming business. Provided that only taxable or GST-free supplies are made through those enterprises, an adjustment under Division 135 of the GST Act is not required. The Act does not exhibit an intention contrary to adopting the plural form of the word. The fact that section 38-480 of the GST Act itself does not require the recipient to carry on the farming business requires that the plural form be adopted.*

The practical effect of this view is to limit the ability to confine a Division 135 issue to the enterprise acquired. Respectfully, such a view is not in keeping with the objects of the Division or the clear wording of the statute. For example, section 135-1 specifies that the adjustment is calculated with reference to supplies made 'in the course of running the concern', wording which is clear that it is the continued operation of the acquired enterprise that is relevant and not an analysis of a broader enterprise carried on by the recipient.

Things which are not part of the acquired enterprise

Division 135 stipulates that it is the nature of the supplies made through the enterprise which dictates whether you have an increasing adjustment. A question then arises where the recipient has acquired things which are not part of the enterprise, but still formed part of the overall transaction and these are later supplied as input taxed supplies. The Commissioner's view outlined in Goods and Services Tax Advice GSTA TPP 092 is that in these circumstances, things which do not form part of the acquired enterprise are not subject to Division 135.

The sale of the enterprise

Another issue to identify the relevant supplies which are made through the enterprise is in relation to the supply of the enterprise itself. In particular, circumstances where the entity has been subject to an initial adjustment under section 135-5, but has later sold the enterprise in its entirety as a GST-free supply of a going concern. The question becomes whether the supply of the enterprise can be used under section 135-10 to 'claw back' the previous increasing adjustment under section 135-5.

The Commissioner outlines his view in relation to the inclusion of the supply of the enterprise itself in the section 135-10 calculation in the ATO Interpretative Decision ATO ID 2007/180. It states:

> *.....the underlying objective of Division 135 of the GST Act is to provide for one or more adjustments to ensure that a recipient of a GST-free supply of a going concern accounts for GST to the extent that the going concern is used for non-creditable purposes.*

In this context, it is appropriate to interpret the phrase 'supplies made through the enterprise' for the purposes of paragraphs 135-10(1)(a) and 135-10(1)(b) of the GST Act to include a supply that is a sale of the enterprise itself.

Therefore, it follows that once the GST-free supply of the enterprise is included in the section 135-10 calculations (via Division 129), the entity will be able to recover the amount of the previous increasing adjustment.

The Division 135 calculation

Initial adjustments

The initial adjustment under Division 135 is calculated by reference to the following formula - 1/10 x Supply price x Proportion of non-creditable use, with 'supply price' and 'proportion of non-creditable use' being defined terms. The "supply price" relates to the price of the going concern acquired by the recipient, while the "proportion of non-creditable use" is a percentage of the supplies you make through the enterprise calculated by reference to their price.

Later adjustments

The mechanics of the calculation under section 135-10 are imported into Division 129 however, the wording and calculation method have been modified between the Divisions. The following table sets out the requisite tests under subsection 135-10(1) with their Division 129 equivalent for the purposes of undertaking the adjustment calculation:

Relevant Test	**Division 135 requirement**	**Division 129 equivalent**
Intention	*the proportion of all the supplies made through the enterprise that you intend will be supplies that are neither taxable supplies nor GST-free supplies*	*in relation to the extent to which you made an acquisition for a creditable purpose*
Application	*the proportion of all the supplies made through the enterprise that are supplies that are neither taxable supplies nor GST-free supplies*	*in relation to the extent to which a thing acquired is applied for a creditable purpose*.

Of note is that the first component of the Division 135 calculation, namely the calculation to arrive at the 'embedded GST' (i.e., 1/10 x Supply price), is not expressly transferred to a Division 129 equivalent. The assumption made is that "acquisition" for the purposes of Division 129, relates to the relevant acquisition of the supply of a going concern or GST free farmland. However, a statutory 'leap of faith' is required to implant the Division 135 "Supply price" calculation into the "Full input tax credit" component of the calculations in sections 129-70 and 129-75.

As there is no mechanism in the Division 129 calculation to produce an 'embedded GST' multiplier, it may well be argued that there can be no effective operation of Division 135-10 (and therefore the adjustment does not occur). This interpretation of the GST Act is arguably supported by the judgment in the PM Developments case, where Logan J considered the authorities on the interpretation of taxing statutes and proceeded on the basis that "the subjection of a person to tax by Parliament requires clarity of language, not inexactitude or indirect references". As a result, Logan J proceeded to apply a literal interpretive approach to (the then) Division 147 of the GST Act.

Importantly, in PM Developments Logan J rejected the Commissioner's submission that doubt about the operation of Division 147 should be resolved pursuant to another Act by reference to the GST Act's Explanatory Memorandum: "An assertion as to its meaning and effect in an explanatory memorandum... is not a substitute for the language employed by the Parliament in the Bill as enacted". Therefore, while the Explanatory Memorandum of the GST Act shows a policy intent to import the mechanics of the

calculation under section 135-10 into Division 129, it is possible that this is ineffective without an express provision in the GST Act to reflect this intention.

Attribution

Initial adjustments

Unlike other adjustment provisions, Division 135 does not contain a specific attribution rule. The GST Act provides that, generally, "[a]n adjustment that you have is attributable to the tax period in which you become aware of the adjustment". However, the Commissioner takes the view that in relation to an increasing adjustment which arises under section 135-5, such an adjustment "is attributable to the tax period in which the entity acquired the GST-free supply of the going concern", even where the entity only becomes aware of the adjustment at a later date. The Commissioner's reasoning is made on the basis that the entity, which initially thought it would make taxable supplies, "only becomes aware in a subsequent tax period that the supplies which, at the time of its acquisition, it intended to make and subsequently made through the enterprise, are neither taxable supplies nor GST-free supplies".

Depending on when the entity 'becomes aware', the Commissioner's interpretation may bring into play the time limitations on GST adjustments as outlined in Schedule 1 to the *Taxation Administration Act 1953*, if such an 'awareness' occurs later than four years after the end of the tax period when the relevant acquisition was made. Of course, an entity cannot become 'aware' prior to the end of the four years and choose not to do something about it until after time has expired as this leaves the entity open to the Commissioner finding they have evaded their tax obligations and this would remove any time limit placed on assessments.

Another implication of the Commissioner's view is that where an entity uses an estimate to calculate the increasing adjustment under section 135-5 at a later time, once it knows the actual component of the calculation, it should be entitled to go back and amend the amount of the increasing adjustment.

Later adjustments

The attribution issue for later adjustments under section 135-10 is more straightforward given the importation of their calculation mechanics to Division 129. The result being that later adjustments are subject to the normal Division 129 rules for the period until the final adjustment period determined pursuant to section 129-20.

3. Farmland

Division 38-O

The purchase and subsequent supply of farmland is very similar to the supply of a going concern both in terms of the requirements and the GST treatment. Under section 38-480, when you supply farmland to an entity who will carry on farming, your sale is GST-free if both the following conditions are met:

> *The supply of a freehold interest in, or the lease by an Australian government agency of or the long term lease of, land is GST-free if:*
>
> *(a) the land is land on which a farming business has been carried on for at least the period of 5 years preceding the supply; and*

(b) the recipient of the supply intends that a farming business be carried on, on the land.

Of note is the provisions of 38-480 do not require a similar choice or agreement from the parties of the transaction similar to that required to achieve GST-free going concern status. If both limbs of section 38-480 are met, the supply will be GST-free. While not an express agreement, it is in the farmland provisions that changing one's mind may have a similar effect. For instance, should the purchaser stop holding the intention to carry on a farming business on the land prior to settlement, the supply would no longer be GST-free.

Before considering the intention in subsection 38-480(b), it is worthwhile looking at what is required under (a) for the intention requirement to be enlivened. The Commissioner has guidelines surrounding what they consider to be a "farming business", which includes a business including the:

(a) cultivating or propagating plants, fungi or their products or parts (including seeds, spores, bulbs and similar things), in any physical environment; or

(b) maintaining animals for the purpose of selling them or their bodily produce (including natural increase); or

(c) manufacturing dairy produce from raw material that the entity produced; or

(d) planting or tending trees in a plantation or forest that are intended to be felled.[7]

The sale of the property is not just the value of the land but also includes all fixtures that are attached to the land that are required for the continued operation of the farm. This treatment and criteria are very similar to the supply of a going concern. Examples of fixtures that are attached to the land are:

- residential property
- fences
- shearing sheds
- workers' cottages
- dams

A farming business of at least 5 years running

The two limbs in section 38-480, require a farming business to have been carried on, on the land for the past five years, and the purchaser intends for a farming business to be carried on. The Commissioner provides his view on the operation of the first limb in paragraphs 3 and 4 of Goods and Services Tax Determination GSTD 2011/2, which state:

> *3. The definite article 'the' in the expression 'the period of five years' in paragraph 38-480(a) indicates that the period in which a farming business must be carried on, on the land, is a continuous period of five years immediately before the supply of the land. This is distinct from the expression 'a period of five years preceding the supply' which may refer to any period of five years before the supply of the land.*

[7] Section 38-475 (2)

4. A farming business is defined in subsection 38-475(2). Specifically, an entity carries on a farming business if it carries on a business of one of the classes of farming listed under paragraphs (a) to (d) in subsection 38-475(2). If an entity carries on a business consisting of one of the classes of farming, the entity is carrying on an enterprise that is a farming business. This is because paragraph 9-20(1)(a) provides that an enterprise is an activity or series of activities done in the form of a business.

Purchaser's intention

The second limb in section 38-480, probably provides no more obvious example of how an intention may be relevant to a GST classification question than anywhere else in the GST Act. For a supplier having to identify, and then rely on, the intention of the recipient of that supply in order to determine their GST liability can be extremely problematical. The use of an intention test in the way drafted, effectively quarantines the GST determination to one side of the transaction (ie the supplier) and would prevent a supplier having to monitor or identify and use post transaction, in order to comply with the GST treatment adopted.

It is important to note that the GST Act does not specify who must carry on the farming business (i.e. there is no requirement the recipient must carry on the farming business themselves). On this point, ATO ID 2005/103 GST and the sale of farmland for simultaneous on-sale relevantly provides:

> *"It is also not necessary for the recipient to carry on the intended farming business. It is the intended use of the land that is important, not who carries on the intended farming business."*

Therefore, the requirement in subsection 38-480(b) will be satisfied as long as the Purchaser has the intention that any farming business be carried on, on the land (regardless of which entity carries on the farming business).

The challenge for the supplier is being able to identify the recipient's intention, including that it relevantly remains in place as at the date of supply. While other intention tests in the GST Act can be viewed objectively, it is arguable the farmland test is a subjective one. To this end, quite possibly the only way for a supplier to lock this down would be for the purchaser to warrant they hold the relevant intent (and will do so as at the relevant date) in the sales contract. It is not evident for there to be any better way for the supplier to protect their position (especially given that a failed warranty may have contractual consequences in relation to GST gross-up clauses, etc should the preferred GST treatment is later found to have not been available).

What should be noted, is the intention test does not require any additional layers of use or intended use of the land that is sometimes the case in other farmland concessions of some state taxes. There, it is often a dominant purpose of the land use that is required to be farming, for the relevant farmland concession to apply. In the GST concession, there is no such additional requirement to a purchaser's intention.

Change of use by the purchaser of GST-free farmland

Like the GST-free going concern provisions, another way that intention is important in relation to the supply of GST-free farmland, is what the purchaser intends to do after the sale of the property. If a purchaser intends to use a property for a reason other than to make taxable sales or GST-free sales in the continued operation of the enterprise, then an adjustment may also be triggered under Division 135.

4. Residential Premises

Definition of residential premises

The GST definition of 'residential premises' contains two discrete tests depending on whether the premises are occupied. An interest in real property will consist of residential premises to the extent that it is either 'occupied' as a residence or 'intended to be occupied, and capable of being occupied' as a residence. Land without certain physical characteristics does not satisfy these requirements, even where the land is adjacent to a residence. The exact definition of residential premises in section 195-1 is as follows:

> *Residential premises means land or a building that:*
>
> *(1) Is occupied as a residence or for residential accommodation; or*
>
> *(2) Is intended to be occupied, and is capable of being occupied, as a residence or for residential accommodation; (regardless of the term of the occupation or intended occupation) and includes a floating home.*

The phrase 'occupied' in this context was considered by the Full Federal Court in *Vidler v Commissioner of Taxation*[8]. In *Vidler*, it was held that vacant land is not land that is 'capable of being occupied as a residence or for residential accommodation', as vacant land must have facilities ordinarily associated with residency.

Whilst it is acknowledged that *Vidler* specifically considered the GST treatment of a vacant block of land, as opposed to the general consideration of land that is adjacent to a residence, the principles in this case are equally relevant. A supply of land should not be input taxed merely because it is situated on a title that includes a residence. Whether, and to what extent, the land comes within the GST definition of residential premises, should depend on the physical characteristics of the land, and whether the land is actually used or 'occupied' as a residence. This is consistent with the two tests set out in the definition of 'residential premises' in section 195-1.

The first test in section 195-1 considers whether land is 'occupied' as a residence or for residential accommodation. The 'occupation' in the context of vacant land will be satisfied only if it can be shown that the occupants of an adjacent residence make use of the land to an extent that is consistent with residential occupation. However, as per the decision in *Vidler*, such occupation will not amount to 'residential premises' unless the land possesses physical characteristics that are ordinarily associated with residency.

The second test in section 195-1 considers whether land is 'intended to be occupied, and capable of being occupied' as a residence or for residential accommodation. Land that is unoccupied (and therefore fails the first test) may still be characterised as residential premises if it can be demonstrated the land is intended to be used for residential purposes, and is capable of being occupied in that manner.

To this end, the importance placed on the 'intention to occupy' characteristic in determining the correct GST treatment was highlighted by the Full Federal Court in *South Steyne Hotel Pty Ltd v Commissioner of Taxation*[9] (see paragraph 21 of the Judgment of Emmett J). Relevantly, Emmett J noted that in the context of the definition of residential premises, the "requirement as to the purpose of the occupation" must still be satisfied.

[8] [2010] FCAFC 59.
[9] [2009] FCAFC 155.

The word 'intended', in this context, was considered by the Full Federal Court in *Marana Holdings Pty Ltd v Commissioner of Taxation*[10]. At paragraph 62 of that judgment, the Full Court held that the words 'intended to be occupied' describes the "intention with which it was designed, built or modified, which intention will be reflected, to greater or lesser extent, in its suitability for that purpose".

Section 40-65

Further to the definition of residential premises, it is important to recognise that a supply of real property that satisfies the definition of residential premises in section 195-1 will not be input taxed unless it also satisfies the requirements of section 40-65. The core requirement of section 40-65 is that the supply of residential premises must be 'used predominantly for residential accommodation', it states:

> *Sales of residential premises*
>
> *(1) A sale of real property is input taxed, but only to the extent that the property is residential premises to be used predominantly for residential accommodation (regardless of the term of occupation).*
>
> *(2) However, the sale is not input taxed to the extent that the residential premises are:*
>
> *(a) Commercial residential premises; or*
>
> *(b) New residential premises other than those used for residential accommodation (regardless of the term of occupation) before 2 December 1998.*

The decision of the Full Federal Court in *Sunchen v Commissioner of Taxation*[11] confirmed this approach, stating that the phrase doesn't refer to use by any particular person, but describes the attributes of the property to which its use is suited at the date of acquisition. The Commissioner outlined a similar view at paragraph 9 of Goods and Services Tax Ruling GSTR 2012/5, that the phrase 'to be used predominantly for residential accommodation' is to be interpreted as a single test that looks at the physical characteristics of the property to determine the premises' suitability and capability for residential accommodation.

As outlined above, section 40-65 places a focus on the physical characteristics of property as evidence of its suitability for its intended use. This is a similar test to that relevant to the definition of residential premises in section 195-1 and therefore the GST jurisprudence involving section 40-65 is relevant to the technical issues at hand.

Sunchen v FCT

This case contemplated the question of how it is determined whether a residential premises is to be used predominantly for residential accommodation. There were two viewpoints, *Sunchen* argued that it should be determined based on the subjective intention of the purchaser. Whereas the Commissioner contended that it is not based upon the subjective intentions of the purchaser, but rather should be determined objectively by the physical characteristics of the property as at the date of acquisition.

In this case, the Commissioner used reasoning from the *Marana Holdings* matter in which the court ruled that; the passive verbal form 'is intended' has as its grammatical subject the connective 'that', standing in place of the words 'land or a building'. The person having the relevant intention is not identified. This sentence structure is commonly used to describe characteristics of the subject of the sentence, which subject is the object of the relevant intention. To say that a building is 'intended' to be

[10] [2004] FCAFC 307.
[11] [2010] FCAFC 138.

occupied as a residence implicitly describes the intention with which it was designed, built or modified, which intention will be reflected, to greater or lesser extent, *in its suitability for that purpose*.' Meaning that the physical characteristics of the building outweigh the purchaser's intentions.

The Commissioner concluded that there is nothing in the terms of subsection 40-65 (1) which suggested the subjective intentions of the purchaser, or for any user for that matter, are relevant to the operation of the section. This omission reinforces that "to be used" is concerned with the physical suitability of the premises being supplied.

5. Adjustment Periods

Change of use adjustments

The construction of new residential premises for the intended use of sale as part of an enterprise, is a taxable supply and ordinarily, the supplier would be entitled to input tax credits for the GST paid on acquisitions relating to their construction.[12] However, where the intention of the supplier changes and the premises are intended to be leased (to any extent), then they will be used in making input taxed supplies of residential accommodation. Relevantly, section 40-35 states that:

> *A supply of premises that is by way of lease, hire or licence (including a renewal or extension of a lease, hire or licence) is **input taxed** if:*
>
> *(a) the supply is of residential premises (other than a supply of commercial residential premises or a supply of accommodation in commercial residential premises provided to an individual by the entity that owns or controls the commercial residential premises); or*
>
> *(b) the supply is of commercial accommodation and Division 87 (which is about long-term accommodation in commercial premises) would apply to the supply but for a choice made by the supplier under section 87-25.*

A change of intention such as that outlined above, may need an adjustment to be made under Division 129, or for acquisitions made after the intention changes, adjustments to the amounts of input tax credits claimed under Division 11.

In relation to change of use adjustments under Division 129, these arise in an adjustment period where:

1. There is a difference between the actual application and the planned or intended application of the thing for a creditable purpose; or

2. There is a difference between the actual application of the thing up to the end of one adjustment period and the actual application of the thing up to the end of the previous adjustment period.

Adjustment periods

The number of required adjustment periods are determined by the GST-exclusive value of the acquisition. The number of adjustment periods are set out below:

[12] Subdivision 40-C.

GST-exclusive value of the acquisition	Adjustment Periods
$1 to $1,000	NIL
$1,001 to $5,000	Two
$5,001 to $499,999	Five
$500,000 or more	Ten

An adjustment period usually ends on 30 June in any year, but the timing and attribution of the acquisition will dictate when the first adjustment period commences. Section 129-20 relevantly states:

> *(1) An adjustment period for an acquisition or importation is a tax period applying to you that:*
>
> *(a) starts at least 12 months after the end of the tax period to which the acquisition or importation is attributable (or would be attributable if it were a creditable acquisition or creditable importation); and*
>
> *(b) ends:*
>
> *(i) on 30 June in any year; or*
>
> *(ii) if none of the tax periods applying to you in a particular year ends on 30 June--closer to 30 June than any of the other tax periods applying to you in that year.*

It follows that it is the attribution of the acquisition that starts the adjustment period clock ticking and not anything else (i.e. it is not triggered by a change in creditable purpose or a change of intention). From then on, it is just a question of how many adjustment periods may apply depending on the GST-exclusive value of the acquisition.

Should there be a change of intention between attribution of the Division 11 input tax credit, and the end of the last adjustment period applying to an acquisition, then an adjustment may apply. In determining a change of use up until the end of the first adjustment period, the timing of that change can impact the length of the time the taxpayer has to make the adjustment. For instance, of a change of intention not long after the acquisition becomes attributable under Division 11, may not need to be adjusted under Division 129 for another 12 months or more where the acquisition is made close to the start of the tax period which is also an adjustment period (i.e. the April – June quarterly tax period or the June tax period for monthly lodgers).

Evidencing the intention

What is clear from the Commissioner's view on change of use adjustments, is that holding an intention that is not acted upon, will be irrelevant. Such a position was tested in the matter of *GXCX v. Commissioner of Taxation* [2009] AATA 569. There, the Administrative Appeals Tribunal considered whether an intention to sell, at some indefinite time in the future, strata-titled residential units that were being leased to tenants, without more, was insufficient to establish that the units were being held for the purpose of sale and applied for the creditable purpose of sale during the relevant adjustment period.

The Commissioner's view on what 'without more' may entail, can be found in GSTR 2009/4, which states:

44. An objective assessment of the facts and circumstances will demonstrate whether or not new residential premises are being held for the purpose of sale as part of an entity's enterprise. Such an assessment requires a weighing up of the evidence that supports a finding that the premises are being held for the purpose of sale or that the premises are being held as an investment asset or for some other purpose. There must be satisfactory evidence to support a conclusion that the premises are being held for the purpose of sale, or for some other purpose. A single piece of evidence may not be sufficient where there is other evidence which suggests a contrary purpose. In such cases all of the evidence must be considered and weighed up in reaching a decision.

45. Although any one factor may not be sufficient on its own, the following are some examples of objective facts and circumstances that the Commissioner would expect to be present to conclude that premises are being held for the purposes of sale. The following is not an exhaustive list and there may be other facts and circumstances in individual cases that will also be relevant to determining if the particular premises are being held for the purposes of sale. In any particular case, the Commissioner would expect there to be a preponderance of relevant factors to support a conclusion that premises are being held for the purposes of sale. Some of the factors that may be relevant include:

- *marketing of the premises for sale, such as, listing the premises for sale with a real estate agent or agents, advertising the premises for sale in relevant publications or via Internet advertising websites for real property, arranging 'open for inspection' times, and showing prospective buyers through the premises;*
- *income tax treatment of the development as trading stock rather than as a capital asset (since treatment as a capital asset would imply that the premises are being held for investment or leasing purposes);*
- *finance documents including loan applications and documentation provided as part of the loan application process supporting the planned sale of the premises;*
- *business plans, feasibility studies or minutes of meetings supporting the holding of the premises for sale;*
- *accounting reports and financial statements supporting the holding of the premises for sale;*
- *past activities of the entity in carrying on the enterprise of selling new residential premises (however, it is noted that, in some cases, special purpose vehicle entities may be established for the express purpose of undertaking a single residential property development for the purpose of sale); and*
- *in the case of a building or complex made up of multiple stratum units, actual arm's length sales of some of the listed units (although, in some cases this may be countered by evidence that the entity only intended to sell some of the premises while intending to lease others).*

Similarly, the Ruling goes on to provide the Commissioner's view on what evidence demonstrates that the premises has been applied, to some extent, in relation to making input taxed supplies includes. This evidence includes:

- business plans, feasibility studies or minutes of meetings demonstrating that the entity has determined to use the premises for lease;

- finance documents including loan applications and documentation provided as part of the loan application process supporting the intention to lease the premises;
- periods of actual leasing of the premises; and
- marketing of the premises for lease.

Timing may also be a relevant factor in determining whether the premises are being held for the purpose of sale. Paragraph 47 of the Ruling provides:

> *In particular, if the premises are intended to be sold within a short timeframe this supports a finding that the premises are being held for the purpose of sale. Alternatively, if the premises are intended to be held for a substantial period of time or in fact remain unsold for an extended period of time this may suggest that the entity is holding the premises as an investment asset or for some other purpose. This is a question of fact in each case and must be weighed up with the other available evidence.*

Calculation

The calculation of any Division 129 adjustment is set out in section 129-40, it states:

> ***Section 129-40 - Working out whether you have an adjustment***
>
> *(1) This is how to work out whether you have an increasing adjustment or a decreasing adjustment under this Division, for an adjustment period, for an acquisition or importation:*
>
> *Method statement*
>
> *Step 1. Work out the extent (if any) to which you have applied the thing acquired or imported for a creditable purpose during the period of time:*
>
> *(a) starting when you acquired or imported the thing; and*
>
> *(b) ending at the end of the adjustment period.*
>
> *This is the actual application of the thing.*
>
> *Step 2. Work out:*
>
> *(a) if you have not previously had an adjustment under this Division for the acquisition or importation--the extent (if any) to which you acquired or imported the thing for a creditable purpose; or*
>
> *(b) if you have previously had an adjustment under this Division for the acquisition or importation--the actual application of the thing in respect of the last adjustment.*
>
> *This is the intended or former application of the thing.*
>
> *Step 3. If the actual application of the thing is less than its intended or former application, you have an increasing adjustment, for the adjustment period, for the acquisition or importation.*

Step 4. If the actual application of the thing is greater than its intended or former application, you have a decreasing adjustment , for the adjustment period, for the acquisition or importation.

Step 5. If the actual application of the thing is the same as its intended or former application, you have neither an increasing adjustment nor a decreasing adjustment, for the adjustment period, for the acquisition or importation.

(2) Actual applications and intended or former applications are to be expressed as percentages.

(3) If the thing is acquired through a reduced credit acquisition and, at the time of the acquisition, it was wholly for a creditable purpose because of Division 70, the extent to which it was acquired for a creditable purpose is the reduced input tax credit percentage prescribed for the purposes of subsection 70-5(2) for an acquisition of that kind.

A critical feature of Division 129 is how (and when) acquisitions are 'applied'. Section 129-55 provides the statutory definition of 'apply' in these circumstances, it states:

Apply, in relation to a thing acquired or imported, includes:

(a) supply the thing; and

(b) consume, dispose of or destroy the thing; and

(c) allow another entity to consume, dispose of or destroy the thing.

Further, the Commissioner expands on this definition in his ATO View contained in Goods and Services Tax Ruling GSTR 2009/4. In particular, paragraphs 33 to 35 of GSTR 2009/4 provide:

33. ...The meaning of apply in section 129-55 is an inclusive definition. Therefore, in addition to the specific references incorporated in the provision, the meaning of apply in section 129-55 also encompasses the ordinary meaning of the term. The ordinary meaning of 'apply' relevantly includes 'to put to use; employ' or 'to devote to some specific purpose' or 'make use of as relevant or suitable; employ'. This indicates the similarity and relevance of 'use' to the meaning of 'apply'.

34. In accordance with the specific references to supply, consume, dispose of and destroy in section 129-55, a thing will be applied in carrying on an entity's enterprise when it is sold, or otherwise disposed of in the course of the entity's enterprise. For example, the sale of a thing constituting part of an entity's trading stock will be an application of that thing pursuant to section 129-55.

35. In accordance with the ordinary meaning of 'apply', a thing that is being held in connection with an entity's enterprise, even though it may not yet have been supplied, consumed or physically utilised, will have been devoted to or put to use in the entity's enterprise. In other words, the thing will have been applied in the entity's enterprise if an objective assessment of the facts and circumstances demonstrates that the thing has been allocated or dedicated to a particular use (or uses) in the enterprise. For example, the holding of trading stock for the purpose of sale in an entity's enterprise will be an application of the trading stock. Similarly, the holding of spare parts in reserve to repair enterprise machinery, as required, will be an application of the spare parts.

A question arises as to when services are applied and specifically, if their intended use is ever different to their actual use in the context of Division 129. To this end, the Commissioner differentiates services

that provide an enduring benefit in the form of the premises (such as repairs and improvements to new residential premises). The Commissioner considers these acquisitions may be subject to an adjustment under Division 129 if the application of the premises changes after the acquisition is made.

However, the Commissioner considers some acquisitions may directly relate to either the sale of the new residential premises or the leasing of the premises. These acquisitions would not be subject to an adjustment under Division 129 as a result of a subsequent change of purpose to leasing or sale, for example:

- acquisitions of services related to the sale of the premises, such as real estate agent and marketing services acquired in relation to selling the premises; and
- acquisitions of services related to the leasing of the premises, such as real estate agent and marketing services acquired in relation to the leasing of the premises.

6. Mixed Use

What are mixed supplies?

Where you make a supply that is identifiable as having more than one part and each part is taxable, you do not need to apportion the consideration for the supply. This is because GST is payable on the whole supply. Similarly, if all of the parts of a supply are identifiable as being non-taxable, GST is not payable on any part of the supply. However, where you make a supply that is a combination of separately identifiable taxable and non-taxable parts, you need to identify the taxable part of the supply. Then you can apportion the consideration for the supply and work out the GST payable on the taxable part of the supply.

The Commissioner's view is that a supply has separately identifiable parts where the parts require individual recognition and retention as separate parts, due to their relative significance in the supply. This view applies where the supply is comprised of a mix of separate things, such as various combinations of goods and services, including the provision of advice. The Commissioner also considers any of the separately identifiable parts that comprise a mixed supply may themselves be composite, being comprised of a dominant part and an integral, ancillary or incidental part.

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GST Implications

GST is payable on a mixed supply, but only to the extent that the supply is taxable. An apportionment of the consideration for a mixed supply between the taxable and non-taxable parts is required to find the consideration for the taxable part. However, before we get to apportioning consideration, we have to identify the relevant components of the supply.

It has been generally accepted that the words 'to the extent' (as used in sections 9-5 and 40- 65) require an apportionment of a supply that has both taxable and non-taxable (i.e. input taxed, GST-free or out-of-scope) components. To this end, if a supply is comprised of an input taxed component (for example, residential premises) and a taxable component (for example, adjacent land that does not form part of residential premises), the supply must be apportioned to determine the value of each distinct part (and, relevantly, the amount of GST payable).

The use or intended use of land by a landowner may be relevant to the mixed supply question on the residential premises/adjacent land example. As stated earlier, it is the Commissioner's view that the phrase 'to be used predominantly for residential accommodation' is to be determined by the physical characteristics that mark out the premises as a residence. It is these characteristics which determine when the use or proposed use of a property is for residential accommodation.

The decision of the Full Federal Court in *Sunchen* confirmed this approach, stating the phrase doesn't refer to use by any particular person, but describes the attributes of the property to which its use is suited at the date of acquisition. However it was also mentioned at paragraph [41] of the judgment that "the use to which an item is actually put will ordinarily be illustrative of at least some aspects of its character".

Based on the reasoning above, arguably the use of land becomes a supporting factor to any determination of whether land is associated with a residence. In some circumstances, the use (and potential nature of the land) of the land will not be conducive to the regular use and enjoyment of a residence (such as industry or farming). In these cases, the land will clearly not form part of the definition of 'residential premises' or be within the terms of subsection 40-65(1).

Whilst the use of the land is not necessarily determinative, usage may provide some guidance as to the character of the property. For example, where the land is used by the landowner to conduct a leasing enterprise, the GST treatment of the adjacent land when sold could be GST-free as a supply of a going concern (as such GST treatment would prevail over the alternative input taxed treatment under section 9-30).

Apportionment must be undertaken as a matter of practical common sense. You can use any reasonable basis to apportion the consideration. Depending on the facts and circumstances of the supply, a direct or indirect method may be an appropriate basis upon which to apportion the consideration and ascertain the value of the taxable part of the supply. The basis you choose must be supportable in the particular circumstances.

7. General tips to support intention

In the context of GST and property matters, it is crucial for taxpayers to maintain comprehensive documentation reflecting their intentions. This documentation serves as support not only for GST classification questions, but also for GST claims on costs incurred in relation to making the relevant supplies.

A suggested list of things to look out for to minimise any dispute with the Commissioner would include:

- Ensuring that any intentions relied on to determine a GST-related outcome, where possible, can be objectively evidenced;
- Keep a record of interactions with external providers or internal decision-making processes that support an intention to ensure this can be produced at a later date if required;
- Look past the transaction and to the intended use of an enterprise or farmland, when acquiring these GST-free;
- Ensuring any contracts that need to capture a party's intention do so in such a way they can be relied upon, or have a fallback gross-up clause should the warranty fail, and additional amounts of GST are required to be pad at a later date;
- Be aware of the timing that changes in intention may have on any change in use adjustments;
- When characterising residential premises, be sure to look at the physical and design characteristics of the property as well as any substantial renovations that could impact the GST treatment; and
- Be prepared for the Commissioner to ask questions – having taxpayers justify their intention is a common area of GST compliance reviews.

The GST as it applies to property continues to be a potential area of risk both now and in the future. Coupled with the Commissioner's continued focus on activities in the property industry, GST compliance continues to be a necessary focus for all property developers or GST registered entities that own or transact in property. It is in this context that it is important to have an awareness of the implications of transactions involving GST and real property to ensure their classification is correct before GST returns are lodged.