

# GST and Real Property

DIVISION 135 ADJUSTMENTS



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# 1. Introduction<sup>1</sup>

As the GST regime<sup>2</sup> becomes increasingly complex, it is more important than ever for entities to be aware of the issues relevant to their industry and the potential areas of risk they may face both now and in the future. Coupled with the ATO's continued focus on activities in the property industry, GST compliance continues to be a necessary focus for all property developers. It is in this context that it is important to have an awareness of the implications of GST reverse charge rules in Division 135 and to ensure their application does not negatively impact on an entity's cash flow or their overall GST position.

This paper intends to outline the GST reverse charge rules in Division 135 in so far as they are relevant to the property industry and explore potential ways to reduce their impact both before and after the relevant acquisition.

## BACKGROUND

Division 135 could be described as one of the biggest 'sleeper' provisions of the GST Act. The potential for the Division to apply following any supply of a going concern and the fact that it can increase the amount of GST payable long after a transaction has been finalised (including possibly the chance to pass on any liability contractually), demands that its application and impact be a constant consideration for advisors and taxpayers alike.

Conceptually, Division 135 performs an apparently simple task within the scheme of the GST Act providing both a 'use' and 'application' test for certain acquisitions. Such tests are similar to those found in Divisions 11 and 129, however the difficulty with the interpretation and application of Division 135 comes from the requirement to identify a particular enterprise and its outputs, which combined with other activity, can be problematical.

### The policy intent

Any detailed consideration of Division 135 should include a review of the policy intent behind the Division. Further, such policy intent may ultimately<sup>3</sup> be relevant to any effective planning undertaken in order to reduce or remove the burden of the provisions. The introduction to Division 135 provides little insight into the policy intent other than outlining there will be an increasing adjustment in prescribed circumstances. Section 135-1 states:

#### **135-1 What this Division is about**

*The recipient of a supply of a going concern has an increasing adjustment to take into account the proportion (if any) of supplies that will be made in running the concern and that will not be taxable*

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<sup>2</sup> Unless otherwise stated, all legislative references are to the *A New Tax System (Goods and Services Tax) Act 1999* (the "GST Act").

<sup>3</sup> The ultimate test of any GST planning is that it does not attract the application of the general anti-avoidance provisions contained within Division 165. The application of Division 165 relevantly includes consideration of the purpose of the relevant section of the GST Act in the matters set out in section 165-15 as well as the scope of the exclusion contained in paragraph 165-5(1)(b).

*supplies or GST-free supplies. Later adjustments are needed if this proportion changes over time.*

Section 135-1 does not indicate the reasons why the increasing adjustment is necessary or specifically, the problem which the Division is designed to address. Paragraphs 6.255 to 6.258 of the Explanatory Memorandum (“EM”) to the GST Bill<sup>4</sup> provide guidance as to the policy intent behind Division 135, which states:

- 6.255 *Under the general rules for supplies there will be GST included in the price for an acquisition. If the acquisition is not entirely for a creditable purpose you are not entitled to a full input tax credit for it. This means that you bear some of the cost of the GST on the acquisition in proportion to your private or input taxed use. However, if the thing you acquire is GST-free and you use it only partly for a creditable purpose there is no GST for you to bear. This applies to acquisitions of going concerns that are supplied GST-free.*
- 6.256 *Division 135 provides for an adjustment to ensure that you account for GST in proportion to the private or input taxed use of a going concern that you acquire. The adjustment increases your net amount by an amount equal to the GST you would bear on the acquisition if it had been a taxable supply to you. The adjustment is equivalent to the difference between what would have been the GST on the supply and the input tax credit you would have been entitled to for the acquisition if the supply had been a taxable supply. This is the effect of section 135-5.*
- 6.257 *This means that you only get a going concern GST-free to the extent that you intend to make taxable supplies with it.*

#### ***Adjustment for change in creditable purpose***

- 6.258 *If what you actually use the going concern for is different from what you intended to use it for when you acquired it, you will have an adjustment for change in creditable purpose under Division 129. See 6.216.*

Prior to commencement, Division 135 underwent further amendment<sup>5</sup> to specify the relevant supplies which trigger the provision to be “not taxable supplies or GST-free supplies” rather than being “input taxed”. This amendment was consistent with the general rules of GST, that is, to ensure acquisitions which are used for private or domestic purposes will also come within the terms of Division 135.

It is important to note that neither of the EM explains the reason why Division 135 only applies to circumstances where you have acquired a going concern or GST-free farm land and why it is not applicable to all GST-free acquisitions. However, it is arguable that those supplies which the limitation applies to feature an element of ‘choice’<sup>6</sup> on behalf of parties to the transaction which dictates the GST treatment whereas other GST-free provisions within the GST Act, do not contain such scope and apply automatically. On this view, it is open to conclude that the purpose of Division 135 is to provide a specific anti-avoidance rule where through the use of a ‘choice’, entities have been able to remove the liability for GST from a relevant transaction.

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<sup>4</sup> A New Tax System (Goods and Services Tax) Bill 1998.

<sup>5</sup> A New Tax System (Indirect Tax and Consequential Amendments) Bill 1999.

<sup>6</sup> For instance, a GST-free supply of a going concern requires both parties to agree that it will be the supply of a going concern and for the sale of farmland, the recipient must decide that it will intend to carry on the farming business.

## The provisions

In form, Division 135 provides two straightforward operations being either, initial or later adjustments. However in substance, the Division contains a number of 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:

#### **135-5 Initial adjustments for supplies of going concerns**

(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 farm land. Much commentary<sup>7</sup> exists on the fact that paragraph 135-5(1)(a) does not stipulate that the going concern had to be a *GST-free* going concern and as a result, double taxation would occur if a ‘going concern’ was supplied but treated as taxable by the parties to the transaction.

Such a view also featured in representations made by the Taxation Institute of Australia in 2001 to the then Treasurer, The Hon. Peter Costello MP.<sup>8</sup> While a literal reading of the provision may support such a view, the Commissioner of Taxation (the “Commissioner”) has not administered the law in this way and it would be expected that any purposive interpretation by a court, would support the Commissioner’s view.

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 problematical. These issues are explored in more detail later in this paper.

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<sup>7</sup> See for example - Timmers M, “Division 135 – Legislative defect: practical problems” (2004) 4 AGSTJ 213 and Stacey P, “GST Developments” Taxation Institute of Australia 2008 Tax Forum, 27-28 May 2007.

<sup>8</sup> Submission by the Taxation Institute of Australia, Goods and Services Tax – Existing Policy & Technical Issues, 5 October 2001, page 13.

## *Calculation – initial adjustment*

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:  $1/10 \times \text{Supply price} \times \text{Proportion of non-creditable use}$  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*

Section 135-10 sets out the relevant “application” test and states the following:

### **135-10 Later adjustments for supplies of going concerns**

- (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).

## THE APPLICATION OF DIVISION 135

### 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.<sup>9</sup> The Commissioner's view outlined in Goods and Services Tax Advice GSTA TPP 092<sup>10</sup> 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 identifying 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.

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<sup>9</sup> For example, a GST-free supply of a going concern of farmland which includes residential premises that is not part of the business.

<sup>10</sup> GSTA TPP 092 - Goods and services tax: If a vendor sells a farm as a GST-free supply of a going concern and the farmland includes residential premises that are not part of the business, is an adjustment required under Division 135 of the GST Act?

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.<sup>11</sup> 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.

### **Interaction with other provisions**

Relevant to any consideration of Division 135 is the interaction (or lack of interaction) it has with other provisions of the GST Act and in particular, the special rules regarding the way entities are organised including GST groups and concessions such as the financial acquisitions threshold ("FAT").

#### *GST groups*

Where larger corporate groups acquire additional business units as part of a GST-free supply of a going concern, the application of Division 135 may become an issue even though the acquired business unit may only make supplies to other members of the same GST group. Supplies between GST group members are effectively ignored for GST purposes by way of subsection 48-40(2) as the supply is "treated as if it were not a taxable supply". Such a supply, while not attracting a GST liability, remains a taxable supply and is not deemed to be any other relevant supply or for that matter, a non-supply (hence the wording "treated as if it were not"). However, this outcome does not prevent Division 135 from applying to GST groups as the statutory fiction imposed by section 48-55 to treat GST groups as a single entity for certain purposes. The inclusion of adjustments as a relevant purpose under section 48-55, means that such intra-group supplies are to be ignored in determining the applicability of the Division.

#### *Financial acquisitions threshold*

The FAT provides input tax credit relief to entities which make only a limited amount of financial supplies. The FAT allows these entities to claim input tax credits, despite the fact they are making input taxed supplies. Division 135 is designed to restore the recipient to the same position as they would be in if they had acquired a taxable supply, however where an entity does not exceed FAT and is subject to the Division, there is arguably an inequitable result.

### **Attribution**

#### *Initial adjustments*

Unlike other adjustment provisions,<sup>12</sup> 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

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<sup>11</sup> ATO ID 2007/180 – Goods and Services Tax: GST and 'supplies made through the enterprise' for the purposes of Division 135.

<sup>12</sup> See for instance section 132-10.

*period in which the entity acquired the GST-free supply of the going concern*,<sup>13</sup> 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 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.

### **The Division 135 calculation**

#### *Initial adjustments*

The initial adjustment under Division 135 is calculated by reference to the following formula:

$$1/10 \times \text{Supply price} \times \text{Proportion of non-creditable use}$$
 (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.

#### *Example A – Initial adjustment*

The following example highlights the application of section 135-5 to the operation of a retirement village:

*In December 2000, Retirement Village Company ("RV Co") acquires a retirement village as part of a GST-free supply of a going concern for \$30M. The village consists entirely of leased, strata titled accommodation. The value of the annual rental returns is \$3.5M. RV Co intends to carry on the leasing enterprise.*

*Following the acquisition, RV Co has an increasing adjustment under section 135-5 payable in the December 2000 tax period. This adjustment is as a result of RV Co making input taxed supplies of residential accommodation to residents.*

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<sup>13</sup> ATO Interpretative Decision – ATO ID 2007/72 – Goods and services tax: GST and attribution of an increasing adjustment for a recipient of a GST-free supply of a going concern.

*In calculating its proportion of non-creditable use, RV Co uses the annual rental returns from the village. The relevant calculation to be made by Dev Co under section 135-5 is as follows:*

$$\begin{aligned}
 & 1/10 * \text{Supply price} * \text{Proportion of non-creditable use} \\
 & = 1/10 * \$30M * (\$3.5M/\$3.5M) \\
 & = \$3M
 \end{aligned}$$

#### *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	<i>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</i>	<i>in relation to the extent to which you made an acquisition for a *creditable purpose; and</i>
Application	<i>the proportion of all the supplies made through the *enterprise that are supplies that are neither taxable supplies nor GST-free supplies;</i>	<i>in relation to the extent to which a thing acquired is *applied for a creditable purpose.</i>

Of note is that the first component of the Division 135 calculation, namely the calculation to arrive at the ‘embedded GST’ ( $1/10 \times$  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 farm land. 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 supported by the judgment in the *PM Developments* case<sup>14</sup>, 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”<sup>15</sup>. As a result, Logan J proceeded to apply a literal interpretive approach to 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

<sup>14</sup> *Deputy Commissioner of Taxation v PM Developments Pty Ltd* [2008] FCA 1886.

<sup>15</sup> At para 27.

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”.<sup>16</sup> 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.<sup>17</sup>

#### *Example B – Initial and later adjustment*

The following example highlights the application of both sections 135-5 and 135-10 to a property development enterprise:

*In June 2003, Development Company (“Dev Co”) acquires a development site as part of a GST-free supply of a going concern for \$24M. Dev Co intends to carry on the planned residential development which features 400 lots with an expected gross realisation of \$100m. As part of Dev Co’s corporate retention policy, it retains approximately 25% of all developments which are rented out to provide constant future income streams. Where appropriate, the retained lots may be returned to the market at some stage in the future depending on prevailing market conditions.*

*As a result of its retention policy, Dev Co intends to make input taxed supplies of residential accommodation in respect of 100 of the developed lots (25%). The price of these supplies on an annual basis will be \$3.0M (rental returns). Following its acquisition of the going concern and given the intention to make a supply that is neither taxable nor GST-free, Dev Co has an initial increasing adjustment under Division 135.*

*In calculating its proportion of non-creditable use, Dev Co uses the expected gross realisation from the development project and the annual rental returns. The relevant calculation to be made by Dev Co under section 135-5 in relation to the initial adjustment is as follows:*

$$\begin{aligned} & 1/10 * \text{Supply price} * \text{Proportion of non-creditable use} \\ & = 1/10 * \$24M * (\$3.0M/\$100M) \\ & = \$0.072M \text{ increasing adjustment}^{18} \end{aligned}$$

*The initial adjustment will be attributable to the June 2003 tax period.*

*In July 2003, Dev Co now decides it will sell off all of the retained lots and by May the following year this had been achieved. These lots are sold as taxable supplies of new residential premises. Following the sell down of the entire development and including updated valuations of the retained lots, the actual gross realisation of the development totals \$100M.*

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<sup>16</sup> At para 47.

<sup>17</sup> Compare and contrast several GST decisions of the Full Federal Court which reveal extensive reference to relevant explanatory memoranda, including *Marana Holdings Pty Ltd v Commissioner of Taxation* [2004] FCAFC 307 at [34]-[43] and [62]; *ACP Publishing Pty Limited v Commissioner of Taxation* [2005] FCAFC 57 per Hill J at [16]-[17]; *HP Mercantile Pty Limited v Commissioner of Taxation* [2005] 126 per Hill J at [16]; *Commissioner of Taxation v DB Reef Funds Management* [2006] FCAFC 89 at [10]; *Westley Nominees Pty Ltd v Coles Supermarkets Australia Pty Ltd v Commissioner of Taxation* [2006] 115 at [50] and *Reliance Carpet Co Pty Ltd v Commissioner of Taxation* [2007] FFAFC 99 at [25] (High Court appeal subsequently allowed).

<sup>18</sup> It should also be noted that based on the Commissioner’s view regarding attribution of section 135-5 adjustments, once the actual realisation is known and as long it is within time, it would be open for Dev Co to go back and recover any overpaid GST. However, it should be noted that such a recalculation may also result in an increased amount of GST payable by Dev Co.

*As a result of its decision to sell the remaining lots, Dev Co will have a later adjustment under Division 135. The relevant calculation to be made by Dev Co under section 135-10 in relation to the later adjustment is as follows:*

$$= (1/10 * \$24M) * [(\$100M/\$100M) - (\$97M/\$100M)]$$

$$= 2.4M * (100\% - 97\%)$$

$$= 2.4M * 3\%$$

*\\$0.072M decreasing adjustment*

The initial adjustment calculation in the above example has been calculated on Dev Co's annual supply estimates however, given the requisite test is one of intention, it would be open to Dev Co to calculate the supply prices immediately following the acquisition and not use sales estimates over a time period of twelve months (or another period of time such as up to the first adjustment period). The difficulty with such an approach in the property context is that sales do not occur everyday, therefore the availability of data to make such an estimate may suggest that using a longer period of supplies to be measured, may provide for a more accurate estimate being made.

Also relevant is that any 'fair and reasonable' method of apportionment based on an immediate estimate would meet the requirements of section 135-5 however, any discrepancy would be accounted for a later adjustment under section 135-10.

## **PREVENTION**

### **Prior to the acquisition**

As part of any effective GST planning, consideration of the downstream impacts prior to entering into a transaction provides the greatest opportunity to relieve or reduce any potentially harsh GST results. Division 135 is a prime example of this approach in that it will only apply in certain circumstances, namely where you are the recipient of a supply of a going concern or of GST-free farm land supplied for farming. Therefore, by not making acquisitions in this way, the later application of Division 135 can be avoided. The relevant question then becomes how this can be achieved while still giving the advantages that attach relevant GST-free supplies including stamp duty savings and reducing the level of funding required for a purchaser.

Firstly, it should be noted that there is some positive action required on behalf of the recipient of a supply of a going concern or of GST-free farmland to acquire something in this way. Such action includes an agreement by the recipient that it is the supply of a going concern<sup>19</sup> and in the case of farm land, the recipient intends that a farming business be carried on, on the land.<sup>20</sup> Therefore, it is open for a recipient to potentially negotiate their way around Division 135 and thus not have later GST problems imposed on them.

### *Removing components of the going concern*

Where identifiable components of a going concern can be removed from the associated GST-free treatment, but do not taint the overall going concern position, this can be a way to relieve the burden of any subsequent adjustments under Division 135. For example, if part of a larger going concern features elements that would otherwise be input taxed, supplying them separately would provide the same

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<sup>19</sup> Paragraph 38-325(1)(c).

<sup>20</sup> Paragraph 38-480(b).

benefits to vendor and purchaser (e.g. stamp duty or finance savings). However, an important consideration would be that the removal of the input taxed components does not prevent the remainder from being treated as a going concern in its own right.

Including such components in a supply of a going concern and then being subject to an adjustment under Division 135, highlights the potential inequity of the Division. The purpose of the Division 135 adjustment is to rectify a scenario where but for the GST-free treatment, there would have been an amount of GST payable and an input tax credit available to an extent. However no such scenario exists if the supply would otherwise have been wholly input taxed. Applying Division 135 to this scenario does not return the recipient to the same position as if they had claimed an input tax credit, it only penalises them to the extent of the adjustment.

## **Following the acquisition**

### *The components of the calculation*

Like any section of the GST Act which requires an apportionment calculation to arrive at the amount of GST applicable, Division 135 provides opportunities to ensure that the apportionment methodology used is not only ‘fair and reasonable’, but also has the potential to advantage the recipient over other methods. An example of this would be in the calculation of an initial adjustment under section 135-5, where the price for the intended supplies is not known. In these circumstances, an estimation may be required to calculate the price for the supplies being made which are not taxable or GST-free however, in making the estimation, there may be number of methods available to arrive at the requisite amount. As long as the method chosen is ‘fair and reasonable’, the obligation is not on the taxpayer to choose the option that results in the highest incidence of tax.

Subject to the Commissioner’s broad view regarding what are considered to be “*supplies made through the enterprise*” which are not being held, it is open for a recipient to limit the supplies that are subject to Division 135 to only those acquired where there is a nexus to the going concern or farming business acquired. Such a view enables the acquired enterprise to in effect be ‘ring fenced’ from other activity and therefore limiting exposure to Division 135. Following this view, it would be open for a recipient to assess what are considered “all things necessary” for the continued operation of the acquired enterprise.

Such a process may identify superfluous items which could potentially be supplied through another enterprise, but not attract the application of Division 135.

### *The timing of any change in intention*

As is the case with broader adjustments under Division 129, the timing of any change of intention under Division 135 can have a significant impact on an entity’s cash flow. For instance, if an entity is considering a change of business activity that would result in it making input taxed supplies (e.g. moving from selling new residential premises to supplying rental accommodation), making that decision in June of any year where adjustment periods still exist will give the entity an almost immediate increasing adjustment. Had the entity delayed making that decision until July, it would have until the end of the next adjustment period (June of following year) before it has to make the increasing adjustment.

### *Ceasing the acquired enterprise*

Under the GST Act, the recipient of a going concern or a farming business has no obligation to actually<sup>21</sup> carry on the respective enterprises following their acquisition. In these circumstances, it may be open for the recipient to close down the acquired enterprise and merge the assets into other enterprises it carries on without attracting Division 135.

However, the effectiveness of such action may depend on whether the Commissioner's position regarding what are “*supplies made through the enterprise*” is sustainable. If the Commissioner's position is ultimately held, it would not matter that an acquired enterprise had ceased, as *any* enterprise conducted by the recipient may be subject to Division 135 if it makes supplies which are neither taxable nor GST-free.

## **CONCLUSION**

The impact of Division 135 can present a real risk for the property sector given their supplies can move quickly from fully taxable to input taxed. Such a risk dictates that the potential application of the Division should be factored into any project feasibility to protect both cash flows and profits. Further, the level of ATO compliance activity in respect of Division 135 means that compliance as well as planning should be a focus of property developers. It would also be beneficial for the Commissioner to articulate his view in relation the application of Division 135 in a ruling soon, as opposed to the current state of affairs where taxpayers are required to obtained guidance from a piecemeal collection of Industry logs and ATO IDs.

An awareness of the GST implications of entering into property transactions, particularly the potential downstream impacts of an entity choosing to acquire a going concern or farming business, is essential when advising in this area of tax or when drafting or reviewing commercial contracts.

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<sup>21</sup> It is noted that in the case of GST-free farm land, the recipient has to intend to carry on the farming business, however it is permissible for such intention to change after acquisition without changing the GST treatment of the earlier supply.