GST AND MARGIN SCHEME DEBACLES

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INTRODUCTION

The GST treatment of real property is undeniably an area of uncertainty and difficulty. The issue for most practising in this area is whether it is getting any better, with the mountains of materials being produced or whether the provisions and administration of them are so hopeless and or precarious, that it is preferable for Parliament to start again. The latter approach is certainly the favoured approach in the recent submissions to the Board of Taxation in response to the Board's Issues Paper, *Review of the Legal Framework for the Administration of the Goods and Services Tax*.[1] For example, in its submission to the Board of Taxation, the Taxation Institute of Australia stated as follows:

> The whole treatment of supplies of residential property needs to be reconsidered to remove the anomalies, administrative difficulties and to avoid the multitude of costly and lengthy disputes that have arisen on the current legislative treatment of residential property for GST purposes... a lot of the issues that will be raised in this Review surrounding property may be better resolved by a more comprehensive review and legislative change…[2]

Similar sentiments were expressed in almost every other submission that covered the issues with real property lodged with the Board of Taxation.[3] The purpose of this paper is to highlight the complexities of the current GST treatment of real property, limited to the margin scheme. In particular, the paper canvasses the *Brady King* cases and the 9 December 2008 amendments to the margin scheme as illustrative of the perennial problems in interpretation and application of Div 75 of the GST Act. Of all the sections in the GST Act, none has been more maligned than Div 75 (Sale of freehold interests, etc).

All references in this paper to the GST Act are to the *A New Tax System (Goods and Services Tax) Act* 1999 (Cth) and all references to Divisions and sections are to Divisions and sections of the GST Act.

MARGIN SCHEME OVERVIEW

The margin scheme is an alternative, concessional method for calculating the amount of GST payable on supplies of real property. In broad terms, the scheme generally allows a supplier to calculate the GST liability on a supply of real property with reference to the increase in the value of the property since it was acquired or, if it was acquired before 1 July 2000 since that date. If the margin scheme is used, then the recipient cannot claim an input tax credit for the GST which is paid on the margin. The rationale for the margin scheme is that the GST regime in Australia is only intended to tax increases in value since GST was introduced on 1 July 2000.[4]

Ironically, while it is quite a simple approach, the margin scheme provisions have been amended on numerous occasions and in a substantial way. Indeed, even before the start of the GST Act, Div 75 was originally limited to the sale of freehold interests and the grant of long term leases, and amendments were made to the GST Bill to clarify the application of Div 75 by including strata unit and other similar titles. The last major amendments to the margin scheme were made in December 2008 and are discussed briefly below, the purpose being to highlight some of the controversial aspects of the application of Div 75 and to show that special rules such as Div 75 (which there is obviously a need for) demand even more special rules to cater for all the permutations.

There is also a litany of cases concerning the margin scheme. One of them, *Brady King Pty Limited v Commissioner of Taxation* [2008] FCA 81, [2008] FCAFC 118 and [2008] FCA 1918 threatened, at first

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[1] Board of Taxation, Issues Paper on the *Review of the Legal Framework for the Administration of the Goods and Services Tax*, 18 July 2008.
[2] Taxation Institute of Australia, *Submission in Response to the Board of Taxation's Review of the Legal Framework for the Administration of the GST*, September 2008, p 7.
[3] See http://www.taxboard.gov.au/content/GST_administration_review/submissions/index.asp.
[4] See Explanatory Memorandum to the *A New Tax System (Goods and Services Tax) Bill* 1998 (Cth) at [6.100]; *Sterling Guardian Pty Ltd v Commissioner of Taxation* (2006) 149 FCR 255 at [16].

instance, to undo the very existence of the margin scheme, to the surprise of all concerned. A debrief of the case and what it reveals about the problems of Div 75 follows.

It is obviously beyond the scope of this paper to traverse all the problems with the margin scheme, however, the manifestation of these is referred to in the Taxation Institute's submission to the Board of Taxation, as follows:

> The problems in this area of the GST legislation are illustrated by the statistics:
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> - Approximately 30% of all GST cases currently in litigation are property related and most of these deal with margin scheme issues;
> - 5 Taxpayer Alerts regarding residential premises (mainly margin scheme issues) have been issued out of only 9 GST Taxpayer Alerts;[5]
> - 12 public rulings (with two more in draft) have been issued on residential property and margin scheme issues;
> - GST audits on margin scheme valuation issues got a special mention in the Inspector General's review of GST audits as being "unfair" and involving "prolonged periods of angst and financial cost to the taxpayers involved"; and
> - The margin scheme provisions, in Division 75, doubled in size after being substantially amended in 2005 and are still the subject of further amendments.[6]

BRADY KING CASES

Brady King Pty Ltd ("*Brady King*") was a property developer which entered into a contract to purchase a commercial property on 22 May 2000. The contract gave Brady King an exclusive licence to start developing the property before the contract settled on 25 October 2000. Brady King developed the property selling 158 strata titled apartments off the plan. It used the margin scheme to calculate its GST liability on the sale of each unit using a valuation of the property as at 1 July 2000 to determine the margin.

First Instance Judgment

At first instance, Middleton J of the Federal Court had to decide two issues. The first was whether the margin scheme could apply in order for Brady King to calculate as its margin, the difference between the selling prices of the units and the valuation of the property as at 1 July 2000 (instead of the acquisition price). The second issue was whether the valuation that Brady King had relied on complied with the GST Act requirements. Middleton J held in relation to the first issue that as Brady King had supplied different legal interests, namely, strata titles, to the legal interest that it had acquired, it was not permitted to use the margin scheme.

In particular, Middleton J put it this way:

> The property (in the juridical sense) that was sold by way of the Supply Contracts was not the same property that was acquired or held (no matter what meaning is given to those terms). Accordingly, s75-10(3) does not apply; the applicant did not on any view acquire or hold before 1 July 2000 the Stratum Unit which it sold, and the requirements specified in the second column of the table were therefore not met. This, in my view, is the correct way to interpret and apply s75-10(3) and the table.[7] (emphasis added)
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> I accept that one should adopt a purposive approach to the interpretation of the GST Act and apply the GST Act in a practical, business-minded way.[8]

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[5] Two further Taxpayer Alerts were issued on 17 February 2009 in respect of GST and real property, one of them, TA 2009/4, is specific to the margin scheme.

[6] Taxation Institute of Australia, *Submission in Response to the Board of Taxation's Review of the Legal Framework for the Administration of the GST*, p 24 (without footnote references). Note that the margin scheme amendments referred to were the subject of Act 145 of 2008, with effect from 9 December 2008.

[7] *Brady King Pty Ltd* v *Commissioner of Taxation* [2008] FCA 81 at [29].

[8] *Brady King Pty Ltd* v *Commissioner of Taxation* [2008] FCA 81 at [30].

> However, I cannot ignore the text of the GST Act, particularly here Div 75, and the clear wording of the operation of the provisions under consideration before me.[9] (emphasis added)

> Therefore, the margin scheme can only apply to the same property, in the juridical sense, being acquired and subsequently sold. The specific wording of s75-10(3), of the table in s75 10(3) and of s75-5(2), and then the specific reference back in these provisions to the supply of the stratum unit in s75-5(1) supports this view.[10]

The judgment of Middleton J was, with respect, a considered approach to the problem. His Honour undoubtedly laboured the points and was troubled with the words of the GST Act as evident from his expressions (including "no matter what meaning is given to those terms"). His Honour simply could not ignore the text of the GST Act. In a nutshell, the GST Act was found by His Honour to be deficient. In view of the conclusion reached by Middleton J on the first issue, his Honour did not need to consider the second issue, namely, whether the valuation that Brady King relied upon to carry out the calculations was compliant.

In the Decision Impact Statement issued by the Australian Taxation Office ("*ATO*") on 11 March 2008, the ATO stated that it respectfully agreed with the decision to dismiss the taxpayer's appeal, however, the basis upon which the Court reached its view was, according to the ATO, both contrary to the submissions made by the Commissioner and the ATO's longstanding practice in relation to the margin scheme provisions as reflected in several public GST rulings and other materials. The ATO assured the property industry that it was not its intention to revise its current rulings in relation to the issues addressed by Middleton J and that it would maintain its views until the outcome of the appeal was known. Therefore, developers who relied upon the current rulings to self assess their GST liabilities under the margin scheme would be protected from any retrospective amendments.

Full Court Judgment

On appeal to the Full Court of the Federal Court, Heerey, Goldberg and Dowsett JJ noted that the Commissioner argued, as did Brady King, that the learned primary judge was wrong in holding that for the purpose of s75-10(3), there had to be a strict identity in juridical terms between what the taxpayer acquired and what it supplied. The Full Court stated as follows, invoking a "practical and fair business operation", in relation to those arguments:

> We agree. The beneficial purpose of the Margin Scheme would be frustrated if such a commonplace transaction as the present one were held to be outside s75-10(3).[11]

> Before 1 July 2000, the Appellant acquired or held each stratum unit in the sense that it held the property at 270 King Street, from which that unit was later carved out. Reading the Act in this way gives it a practical and fair business operation. It is a construction which is reasonably open and closely conforms to the legislative intent.[12]

Turning to the issue of whether Brady King held or acquired the necessary interest before 1 July 2000, the Full Court further noted as follows:

> On this issue, the Commissioner and the appellant parted company. But, in our view, once the "precise juridical identity" approach is rejected and a more practical construction adopted, it is not possible to ring fence the interest the appellant acquired under the contract from the stratum unit which it later supplied to its customer.[13]

The Full Court observed that the following arguments were put to it:

> The Commissioner argued that the stratum units which the appellant sold were not "derived" from the equitable estate held as purchaser, rather they were derived from the fee simple estate it obtained on completion of the purchase and registration (although senior counsel for the Commissioner disavowed any argument that was acquired or held was the registered interest). But that fee simple was not conferred on the appellant by the Lands Titles Office without regard to anything the appellant had previously done to acquire it. The appellant was only able to complete the purchase and obtain registration because, by entering into the contract, it had obtained or acquired enforceable rights against (and of course obligations to) the previous owner of the property. The contract was the genesis or source of the

[9] *Brady King Pty Ltd* v *Commissioner of Taxation* [2008] FCA 81 at [32].
[10] *Brady King Pty Ltd* v *Commissioner of Taxation* [2008] FCA 81 at [35].
[11] *Brady King Pty Ltd* v *Commissioner of Taxation* [2008] FCAFC 118 at [23].
[12] *Brady King Pty Ltd* v *Commissioner of Taxation* [2008] FCAFC 118 at [24].
[13] *Brady King Pty Ltd* v *Commissioner of Taxation* [2008] FCAFC 118 at [26].

> appellant's interest in the stratum unit it supplied. In the language of the Commissioner's submissions, the contract was the parent.[14] (emphasis added)

In the Decision Impact Statement issued by the ATO on 12 August 2008, the ATO stated that it considered the Full Court's decision as authority for the proposition that, for the purposes of s.75-10 and s.75-11 of the GST Act, an entity supplying relevant property is taken to have held or acquired a sufficient interest in that property at a particular time if it had entered into, but not completed, a contract for its acquisition. The ATO noted that it does not consider that it follows from the decision that a supply of the relevant property occurs at the time of entry into a contract for the sale and purchase of that property, but that it continues to consider that a supply of land under a standard land contract occurs upon completion of the contract.

Remitted Back to Middleton J on Valuation

The matter was then remitted back to Middleton J of the Federal Court to determine whether the valuation obtained by Brady King complied with the requirements of s.75-10(3) of the GST Act: *Brady King Pty Ltd v Commissioner of Taxation* (No.2) [2008] FCA 1918. Middleton J held that the valuation obtained by Brady King did not comply. It was agreed that valuations for the purposes of determining the margin had to be made in compliance with the requirements determined in writing by the Commissioner, in this case under Method 1 of the *A New Tax System (Goods and Services Tax) Margin Scheme Valuation Requirements Determination (No 2) 2000*. Relevantly, clause 4 of that Determination confirms that Method 1 is about the valuation of partly completed buildings. That method is also known as the hypothetical development method valuation. The Determination prescribes at clause 5 that, under Method 1, the valuation must be provided by a professional valuer and the valuer must have regard to the:

(a) market value of the completed premises;

(b) cost to complete the partly completed premises; and

(c) profit margin and holding costs that are attributable to the period on or after the valuation date.

His Honour made several general observations about aspects of the Determination and the valuation obtained by Brady King. His Honour said that it was clear that the valuation must be provided by a professional valuer and that there could be no middle course here. Equally, his Honour said that the valuer "must" have regard to the three matters earlier referred to. His Honour also went on to say that these matters would need to be given appropriate weight as important or essential elements in the making of the valuation. His Honour also stated, to the relief of many taxpayers and valuers:

> However, just because another valuer may come to a different valuation figure does not mean the valuation relied on may not be in compliance with the requirements of s.75-10(3) and the Determination. Within any valuation, there will be matters of subjective judgement undertaken by the professional valuer based upon his or her expertise and experience.[15]

His Honour explained that the methodology simply requires the valuer to assess the market value of the completed premises as at 1 July 2000, and then subtract from this figure, the cost to complete the partially completed premises and the profit margin and holding costs. What is left is the price that the hypothetical developer would pay for the partially completed premises on 1 July 2000, and that was the value of those premises on 1 July 2000. His Honour then turned to examine six specific matters that the Commissioner relied on in support of the argument that the valuation obtained by Brady King did not comply. As with all issues, particularly those combining questions of fact and law, the devil is in the detail. It follows also that with valuations, it is only upon proper scrutiny of the facts of the valuation that one can assess whether it complies.

With respect to the market valuation of the completed premises, Middleton J held that the valuer failed to take into account actual sales prices after 1 July 2000 although such prices were available to him. His Honour noted that this was a fundamental error which affected the validity of the valuation.

The second aspect addressed was the profit margin that the hypothetical developer would require. It appeared that the valuer had used a margin for profit and risk of 25%, however, the evidence revealed that the valuer had not accounted for the GST on the sales of the units and the GST payable would

[14] *Brady King Pty Ltd* v *Commissioner of Taxation* [2008] FCAFC 118 at [27].
[15] *Brady King Pty Ltd v Commissioner of Taxation* (No.2) [2008] FCA 1918 at [30].

reduce the developer's profit margin well below 25%. The failure to properly consider a GST outgoing of approximately $2.5 million in the hypothetical developer's profit margin calculation was considered to be contrary to the requirements of the GST Act and, putting aside the quantum involved, such non-compliance rendered the valuation invalid.

The third issue was the interest on acquisition costs. The interest costs were broken into two heads, namely, interest for funds that a hypothetical developer would have to borrow to pay for the construction costs and interest for funds the hypothetical developer would require to acquire the property. The Commissioner accepted that the interest costs on the construction budget were acceptable. However, the second head of interest based, not on the cost that the hypothetical developer would have paid on 1 July 2000 to acquire the property, but on the lesser figure being the cost the taxpayer actually incurred to acquire the property in May 2000 was incorrect. His Honour held that, again, the valuer had misdirected himself as to the correct valuation approach in that the valuation did not properly take into account the holding costs and as a consequence of such failure, the valuation was invalid.

The fourth issue was that the valuation did not make any allowance for rates being a holding cost. His Honour held that if this were the only failure to comply with the Determination, then an issue may arise as to whether the valuation was invalid on this basis alone. However, because of the other failures, he did not need to consider the consequence that may flow from this particular failure. Middleton J also turned to the absence of land tax being accounted for as a holding cost and, as with the issue of the rates, noted that the amount of land tax to be allowable was minimal and may in other circumstances have impacted on whether the valuation should be regarded as valid. His Honour did not need to consider this issue in the light of his other conclusions as to the validity of the valuation.

Finally, the sixth issue noted by His Honour was that the valuation made no allowance for the stamp duty and legal costs that the hypothetical developer would bear with respect to the acquisition of the property on or after 1 July 2000 as part of the development. In this regard, His Honour found such costs are not relatively minor and, on this basis, the valuation was also invalid.

The ATO has noted in the Decision Impact Statement issued with respect to this case that Brady King has lodged a notice of appeal against that decision to the Full Court of the Federal Court. The dispute, in other words, in respect of Brady King’s valuation is apparently not over, although it is fair to say that the judgment goes some way to explaining some commonly disputed aspects of a valuation. With respect, the judgment deals with the issues raised by the Commissioner in a fairly comprehensive way and it does not appear that Brady King would be in a position to overcome all of the difficulties. Put simply, there were certain factors that the valuer was bound to consider, which he apparently did not.

The Commissioner has separately foreshadowed for some time, dating back to at least November 2007[16] that he proposes to issue a further legislative determination with respect to margin scheme valuations. That determination is aimed at setting out the circumstances in which the Commissioner can substitute his own valuation, where it is considered that the taxpayer’s valuation is non-complying. In addition, the substituted valuation may then possibly form the basis of an assessment in respect of which the taxpayer can lodge an objection. It remains to be seen how this will work in practice.

Comments on Brady King

The *Brady King* cases are remarkable for bringing to the attention of everyone, including the Commissioner, fundamental flaws in Div 75 of the GST Act. Undoubtedly, it was a happy outcome that the Full Court was able to see its way to finding that the margin scheme rules could apply and were effectively not obliterated from the GST Act, but the position was undoubtedly a precarious one. It is quite conceivable, with respect, that the Full Court of the Federal Court could have gone the other way and endorsed the approach of Middleton J at first instance. Presumably, the Commissioner would have brought this possibility to the attention of Treasury and been ready to move with retrospective amendments (to 1 July 2000) as a solution to the problem.

The Full Court’s judgment, with respect, is not entirely satisfactory. The following reasons, being critical to reversing Middleton J, create a whole host of other issues for those analysing GST and property transactions:

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[16] See ATO NTLG GST Sub-group Minutes, 3 December 2008 – Issue 1.50 – PTI 982 – Margin scheme determination – valuation issues.

> The appellant [BradyKing] was only able to complete the purchase and obtain registration because, by entering into the contract, it had obtained or acquired enforceable rights against (and of course obligations to) the previous owner of the property. The contract was the genesis or source of the appellant's interest in the stratum unit it supplied. In the language of the Commissioner's submissions, the contract was the parent.[17]

One of the questions which emerged from the above was whether “off the plan” sales of strata title units exchanged before 1 July 2000, including by the developer with end consumers, were acquired by the end consumers before I July 2000 as “the contract was the genesis”. If so, what would be the GST margin scheme consequences? It will be remembered that the timing of the commonplace occurrence of the supply of real property is not specifically addressed in the GST Act (although the GST Transition Act contains provisions aimed at determining when the property is made available when contracts straddled the start of GST). The *Brady King* cases, therefore, alluded to other issues with the GST treatment of real property which are threshold issues. On the other hand, problems with valuations of real property, as being explored in the appeal by Brady King to the Full Court, are always going to be an area of contention, as in other taxes.

AMENDMENTS TO THE MARGIN SCHEME WITH EFFECT FROM 9 DECEMBER 2008

Significant amendments were made by the *Tax Laws Amendment (2008 Measures No. 5) Act* 2008 with effect from 9 December 2008 to the operation of the margin scheme. The changes close gaps in the legislation that were identified some years ago but which were not pursued at the same time as other amendments were made to the margin scheme. The amendments are best understood in the context of the history.

Prior to these amendments, a supply of property was ineligible for the margin scheme if the entity supplying it acquired the property as a taxable supply under the basic rules (i.e. if the margin scheme was not applied the last time the property was supplied). However, if the property was supplied as a taxable supply but then supplied as a GST-free supply (i.e. either as part of a supply of a going concern or as GST-free farmland) or as a supply to a registered associate for no consideration, a further supply of the property was again eligible for the margin scheme. This was because the eligibility of the margin scheme was "refreshed".

Furthermore, the effect of this was that the difference in consideration paid when the property was supplied as a GST-free supply was not taxed and only the margin between the GST-free supply (or the non-taxable supply to a registered associate) of the property and the final taxable supply was taxed for GST purposes. The recent amendments closed these gaps by stopping the "refreshing" of the margin scheme and the "resetting" in the calculation of the margin. The amendments also extended the application of the general anti-avoidance provisions.

The Basic Changes

There are two important aspects to how the amendments apply. First, a supply is no longer eligible for the margin scheme if the previous supplier (i.e. the entity which supplied the property to the current supplier) acquired its entire interest in the property as a taxable supply not subject to the margin scheme. That is, if the margin scheme was not applied to a supply of property, the next supply of that property would remain ineligible for the margin scheme. The new eligibility provisions only disqualify the application of the margin scheme with respect to the GST treatment of the immediately preceding transaction, i.e. it is only necessary to look back one sale to determine whether the entity that sold the property to the current vendor was entitled to use the margin scheme.

Second, in the case where property is acquired as part of a GST-free supply of a going concern or as farmland or through a non-taxable supply to an associate, and then supplied using the margin scheme, the GST Act now broadly provides that the margin to be calculated is the difference between the price the entity sells the property for and the price the prior owner acquired the property for (or an approved valuation of the property as at the day on which hthe prior owner acquired the property): see s 75-11(5). The effect of this is that the part of the consideration (for example, in the first GST-free supply) which previously remained untaxed is taxed as a result of these amendments to the GST Act. In other words, where a taxpayer typically acquires property under a GST-free supply (after 9 December 2008) and later

[17] *Brady King Pty Ltd v Commissioner of Taxation* (No.2) [2008] FCA 1918 at [27].

sells the property under the margin scheme, GST will need to be calculated on the value added by the taxpayer, as well as the value added by the entity from which the taxpayer acquired the property. This prevents the GST liability from being reduced by resetting the margin as a result of a supply at an inflated price by way of a GST-free supply.

The general anti-avoidance provisions in the GST Act were also extended to defeat contrived arrangements, such as the artificial interposition of two or more GST-free supplies for the purpose of reinstating eligibility of the margin scheme. This was achieved by qualifying the exemption in s.165-5(1)(b) to the application of the anti-avoidance provisions where the GST benefit is attributable to the making of a choice, election, application or agreement expressly provided for by the GST Law. This is because the exemption does not apply where a scheme was entered into with the sole or dominant purpose of creating a circumstance or state of affairs to enable that choice, election, application or agreement to be made: s 165-5(3). These anti-avoidance amendments are not necessarily confined to the margin scheme as they are contained in the general anti-avoidance provisions rather than Div 75, however, according to the Explanatory Memorandum to the Bill, are designed to capture a string of GST-free or non-taxable transactions which distort the margin scheme calculations[18].

Transitional Rules

These margin scheme amendments apply to “new supplies” that occur on or after the date of royal assent, namely, 9 December 2008. Only property acquired on or after 9 December 2008 is impacted, in that the amendments are entirely prospective, even though the measures were described in the Explanatory Memorandum as “integrity” measures. Property that was acquired under either a written agreement which was entered into before 9 December 2008 or an option or right entered into prior to 9 December 2008, and which identified the supply and consideration, is not affected and the previous margin scheme rules apply. In the future, residential property developers will have to undertake additional due diligence enquiries in respect of the property that they are acquiring if they intend to use the margin scheme on subsequent sales. It is expected that a number of additional warranties and indemnities will also be drafted into GST special conditions in sale contracts where the application of the margin scheme is critical to the feasibility of a development.

Comments on Margin Scheme Interactions

These margin scheme amendments (and many of the prior amendments) reveal that the major fault is not Div 75 itself nor the policy underpinning it, but the interaction of the margin scheme provisions with other provisions in the GST Act. It is evident that the special provisions in Div 75 were not designed against the background of the other basic and special provisions, e.g. margin scheme rules do not gel with Div 184 (Entities, in particular, partnerships), Div 38 (GST-free supplies), Div 72 (Associates), nor Divs 105 and 147 (Supplies in Satisfaction of Debts and Representatives of Incapacitated Entities). It is hoped that a comprehensive review of the GST treatment of real property (if recommended by the Board of Taxation) will canvass the spectrum of issues and rules that overlap. It is expected that some of the solutions lie in other provisions, for example, with respect to partnerships rather than in Div 75 itself, however, what is clear is that little thought was given to these interactions in the first place.

13 March 2009

[18] Explanatory Memorandum to the Tax Laws Amendment (2008 Measures No.5) Bill 2008 para 1.53.