GST and the margin scheme: application of the valuation method

BRADY KING PTY LTD V COMMISSIONER OF TAXATION [2008] FCA 81.

INTRODUCTION

On 18 February 2008 the Federal Court handed down its decision in *Brady King Pty Ltd v Commissioner of Taxation*[1]. This case arose as a result of Brady King Pty Ltd's ("taxpayer") choice to calculate the GST payable on the sales of stratum units under certain margin scheme provisions in the A *New Tax System (Goods and Services Tax) Act 1999* ("GST Act"). The Federal Court upheld assessments issued by the Commissioner of Taxation ("Commissioner") calculating the GST payable on the sales of stratum units by the taxpayer under s 75-10(2) of the GST Act, which refers to the margin as the difference between the eventual sale price and the *cost* to the taxpayer of acquiring the stratum unit. The Federal Court disallowed the taxpayer's appeal that s 75-10(3) of the GST Act was instead applicable to its circumstances, which provided for the margin as the difference between the eventual sale price and the *value* of each stratum unit as at 1 July 2000.

The Federal Court made its findings contrary to the submissions of the Commissioner, on the basis that for s 75-10(3) to apply, the property held or acquired must be the same as the property subsequently sold. The Court also held that s 75-10(3) of the GST Act applied only to legal interests and not equitable interests. The Commissioner has since released a decision impact statement in relation to the findings of the Federal Court, indicating that whilst the Commissioner agrees with the Court's decision, the Court's reasoning does not completely endorse the Commissioner's longstanding practices in relation to the margin scheme.

BACKGROUND

The taxpayer entered into a contract of sale on the 22 May 2000 ("Purchase Contract") in which it contracted to buy an office building located in King Street, Melbourne ("Property") for approximately $9.2 million. Under the terms of the Purchase Contract, the taxpayer was to pay a deposit of $100,000 upon exchange of contracts, a further amount of $400,000 90 days later and the balance of $8,750,000 on the settlement date. Settlement occurred on 25 October 2000 and the transfer of land was registered on 9 November 2000. The structure of the Purchase Contract resulted in the taxpayer having full legal and equitable interest in the Property from 25 October 2000. Prior to the settlement date and relevantly on 1 July 2000, the taxpayer had only an equitable interest in the Property pursuant to the Purchase Contract.

Under the Purchase Contract, upon exchange and payment of the first deposit, the taxpayer was granted an exclusive license to enter the Property for the purpose of conducting certain building works. As a result, although the taxpayer did not gain possession of the Property until the balance of the purchase price was paid upon settlement, the Property was at the taxpayer's risk from the date of sale.

On 26 June 2000, the taxpayer obtained planning approval for the construction of several units on the Property and began to carry out works on the Property under the exclusive license. The taxpayer was registered for GST on 1 July 2000.

Settlement occurred on 25 October 2000 and the taxpayer completed its development of the Property into 158 units, each of which qualified as a stratum unit under s 124-190 of the *Income Tax Assessment Act 1997* ("Stratum Units").

Between April and November 2001, the majority of the Stratum Units were sold "off the plan" before construction was completed, pursuant to contracts of sale for lots on a proposed plan of subdivision ("Supply Contracts").

On 25 January 2002, the taxpayer engaged Colliers Jardine to value each of the Stratum Units as at 1 July 2000 in order for the taxpayer to assess the GST payable using the margin scheme provisions found in Div 75 of the GST Act. Colliers Jardine valued the whole of the Property as at 1 July 2000 as $23,232,000.

The Supply Contracts were settled from 28 March 2002 and only four of the Stratum Units remained unsold. The taxpayer calculated the GST payable on the supply of each Stratum Unit under s 75-10(3) of the GST Act using the valuations provided by Colliers Jardine.

In June and October 2004, following lodgment of GST returns by the taxpayer, the Commissioner issued assessments in which the GST payable was calculated pursuant to s 75-10(2) of the GST Act. The taxpayer then appealed the Commissioner's assessments, which is the subject of the present case.

RELEVANT LEGISLATION

Where a taxpayer makes a taxable supply of "real property" by selling a "freehold interest in land", selling a "stratum unit" or granting or selling a "long term lease", they may choose to apply a margin scheme in calculating the GST payable, under s 75-5 of the GST Act. That is, GST is calculated

on the **margin** and not on the "value" of the taxable supply as is normally the case under s 9-75 of the GST Act.

"Real Property" is defined under the GST Act to include:

(a) any interest in or right over land; or

(b) a personal right to call for or be granted any interest in or right over land; or

(c) a licence to occupy land or any other contractual right exercisable over or in relation to land[2].

Section 75-10 provides that:

(1) If a taxable supply of real property is under the margin scheme, the amount of GST on the supply is 1/11 of the margin for the supply.

(2) Subject to subs (3) and s 75-11, the ***margin*** for the supply is the amount by which the consideration for the supply exceeds the consideration for your acquisition of the interest, unit or lease in question.

(3) Subject to s 75-11, if:

(a) the circumstances specified in an item in the second column of the table in this subsection apply to the supply; and

(b) an approved valuation of the freehold interest, stratum unit or long-term lease, as at the day specified in the corresponding item in the third column of the table, has been made;

the ***margin*** for the supply is the amount by which the consideration for the supply exceeds that valuation of the interest, unit or lease.

(3A) If:

(a) the circumstances specified in item 4 in the second column of the table in subs (3) apply to the supply; and

(b) there are improvements on the land or premises in question on the day on which the taxable supply takes place;

the valuation is to be made as if there are no improvements on the land or premises on that day.

(4) This section has effect despite s 9-70 (which is about the amount of GST on taxable supplies).

For the purposes of the present case, the relevant items of the table are as follows:

Item	When Valuations may be used	Date of Valuation
1	The supplier acquired the interest, unit or lease before 1 July 2000, and items 2, 3 and 4 do not apply	1 July 2000
3	The supplier is ˚registered or ˚required to be registered and has held the interest, unit or lease since before 1 July 2000, and there were improvements on the land or premises in question as at 1 July 2000.	1 July 2000

In addition, the valuation used must comply with any written requirements determined by the Commissioner from time to time for the making of valuations for the purposes of Div 75.

In the present case, the taxpayer applied the valuation method under s 75-10(3) to determine its GST liability on the basis that it held the Property before 1 July 2000 (Item 3) or in the alternative, that it acquired the Property before 1 July 2000 (Item 1). Calculation of GST in accordance with s 75-10(3) rather than s 75-10(2) may have resulted in a smaller GST liability for the taxpayer.

ISSUES BEFORE THE COURT

Justice Middleton was asked to consider the following issues by the taxpayer:

1. whether the taxpayer was entitled to determine its GST liability using the valuation method in s 75-10(3), such that GST was calculated on the difference between the sale price of each Stratum Unit and the value of that Stratum Unit as at 1 July 2000. The Federal Court was not asked to consider whether the Commissioner had correctly applied s 75-10(2); and
2. if the Court answered the first issue in the affirmative, whether the valuation used in determining the GST liability, complied with the requirements of s 75-10(3).

In this regard, the Commissioner submitted to the Court that:

1. the taxpayer could not have *acquired* or *held* the Stratum Units as required by s 75-10(3) of the GST Act. This was because the taxpayer only gained a legal interest in those Stratum Units upon registration of the plan of subdivision after 1 July 2000 – at 1 July 2000 the Stratum Units did not exist.
2. the concepts of "interest, unit or lease" for the purpose of s 75 of the GST Act should be interpreted in accordance with the Full Federal Court's decision in *Sterling Guardian*[3], being that the taxpayer could only be held to have acquired the Stratum Units on 1 July 2000 if the taxpayer had a legal interest in the parent title on that date. In accordance with that approach, it would not be relevant if the Stratum Units were not in existence on 1 July 2000.

FEDERAL COURT DECISION

The Federal Court dismissed the taxpayer's appeal, holding that the taxpayer was unable to apply the margin scheme in accordance with s 75-10(3) of the GST Act. Whilst Justice Middleton agreed with the Commissioner that the taxpayer was not eligible to apply the valuation method under s 75-10(3), his Honour did not agree with the Commissioner's reasoning.

Instead, the Federal Court held the valuation method in s 75-10(3) was not available to the taxpayer because the property that was sold by way of the Supply Contracts was not the same property that the taxpayer had acquired or held before 1 July 2000. Put another way, on 1 July 2000, the taxpayer did not acquire or hold the Stratum Units which it sold pursuant to the Supply Contracts. As a result, the requirements of s 75-10(3) could not be satisfied so that the method of calculation available under that section would be available to the taxpayer.

Was the taxpayer entitled to use the margin scheme pursuant to section 75-10(3)?

It was clear to the parties that there was no previous authority which directly considered the issue of whether the margin scheme was available to the taxpayer under these circumstances. In light of the lack of relevant authorities, the Court was particularly careful to reach a decision that would accord with the underlying purpose of the margin scheme and the situations to which it was intended to apply.

Justice Middleton reasoned that s 75-10(3) could only apply where what was acquired and then sold was the same property, as was clear from the references in the relevant provisions to "the" unit, and the unit "in question". His Honour reasoned that this wording clearly demonstrated that the margin scheme envisaged a comparison between "the same units, and for that matter, the same interests or leases"[4]. In his Honour's view, the wording of subss 75-10(1), (2) and (3) supported this interpretation.

In an effort to repute this approach, the taxpayer made reference to s 75-15 which provides for the apportioning of the total consideration paid for the freehold interest in land, stratum unit or long-term lease if what is supplied relates only to part of the land or premises acquired. The taxpayer submitted that s 75-15 envisaged supplies where the property sold was not identical to the property acquired. However, this submission was rejected by the Court and his Honour held that s 75-15 was simply a mechanism for calculating the margin when only a part of what is acquired is subsequently sold. The Court maintained that s 75-15 did not change the conclusion that in order to apply the margin scheme, the property supplied must be the same as the property acquired.

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As the Stratum Units differentiated from the Property acquired, accordingly, the taxpayer was unable to apply the margin scheme under s 75-10(3).

The meaning of "held" and "acquired" in section 75-10(3)

Whilst his Honour's determination as to the correct interpretation of s 75-10(3) dealt with the issues at hand, Justice Middleton went on to comment on the proper meaning of the terms "held" and "acquired" within the section. Justice Middleton stated that the words must be considered in the context in which they appear and in light of the purpose for which they were adopted. The Court was of the view that the terms "held" and "acquired" refer to the same concept and are used similarly in s 75-10(3). While item 1 in the table refers to the relevant interest as having *been acquired* before 1 July 2000, and item 3 as *held* since 1 July 2000, his Honour maintained that "the scope of the word "acquire" is to be determined by the scope of what is meant by "interest, unit or lease", and so is the word "held"[5].

It followed then that the phrases "freehold interest in land", "stratum unit" and "long-term lease" should be considered and in particular, whether the phrases encompassed both equitable and legal interests, or legal interests only. If the term "unit" did in fact include equitable interests it might be said that acquisition or holding could occur on the entering into a contract of sale for that unit.

The Court observed that neither the first instance decision nor the Full Court decision in *Sterling Guardian* decided this issue; Justice Middleton therefore considered the terms in light of the Explanatory Memorandum ("EM"). Although the EM provides that the margin scheme is to apply to supplies of real property that are held as at 1 July 2000, his Honour considered this statement to be too wide in the context of the actual terms of the GST Act. The Court stated that while the definition of "real property" is wide under the GST Act, s 75-10(3) restricts the application of the margin scheme to specific sub-sets of real property, namely the juridical concepts of the three forms set out, "freehold interest in land", "stratum unit" and "long-term lease". Justice Middleton concluded that the phrases refer to legal interests only, given that they are generally used to refer to legal interests and have accepted and well-known meanings. In particular, the reference to a stratum unit is a reference to a defined term and one which is confined, for the most part, to a registrable interest created by statute.

The taxpayer argued that such an approach to the interpretation of s 75-10(3) would lead to anomalies in the use of the margin scheme not intended by Parliament. Such anomalies, it was contended, would arise where for instance a person acquired land under a terms contract some years prior to 1 July 2000 but did not settle the contract until after 1 July 2000, or where a person acquired a long-term lease before 1 July 2000 but failed to register that lease until after 1 July 2000. In each of these cases, under the approach adopted by the Court, the taxpayer would be ineligible for the valuation method under s 75-10(3).

However, the Court held that such examples were not inconsistent with the legislative purpose behind s 75-10(3) and considered that to read the section so as to limit the margin scheme to legal interests only was not to frustrate Parliament's intentions. Rather, this approach reasonably set boundaries to the concessions provided by Parliament. In reaching this conclusion, Justice Middleton also observed that if Parliament had in fact intended for the margin scheme to apply to equitable as well as legal interests, his Honour would expect the legislature to have been explicit in its description of the interests to which the section applied.

Given the Court's decision with regard to the first issue raised, Justice Middleton did not consider the second issue of whether the valuations relied on by the taxpayer complied with s 75-10(3).

COMMENT AND CONCLUSION

On 18 February 2008 the Federal Court handed down its decision in *Brady King Pty Ltd v Commissioner of Taxation*. This case arose as a result of the taxpayer's choice to calculate the GST payable on the sales of stratum units under s 75-10(3) of the GST Act. The Federal Court dismissed the taxpayer's appeal that the GST payable on the sales of the Stratum Units should have been calculated in accordance with s 75-10(3) of the GST Act. The Federal

Court was not asked to consider the Commissioner's assessment of the taxpayer's GST liability in accordance with s 75-10(2). While the Commissioner submitted that s 75-10(3) was not available to the taxpayer because the Stratum Units did not in fact exist as at 1 July 2000 because the taxpayer had at that time only an equitable interest in the parent title and not a legal one, the Court came to this conclusion contrary to the Commissioner's submissions. The Court maintained that in order to apply the valuation method in s 75-10(3), the property held or acquired must be the same as the interest that is the subject of the taxable supply. As the Stratum Units differed to the Property held prior to 1 July 2000, the taxpayer did not have this method of valuation available to it. In addition, the Court made it clear that the interests to which s 75-10(3) apply are legal interests only; where the taxpayer holds only an equitable interest in a "freehold interest in land", "stratum unit" or "long-term lease" on or before 1 July 2000, the taxpayer cannot make use of the valuation method.

The case is a timely reminder to taxpayers to use caution when applying the margin scheme under Div 75. In particular, taxpayers must be mindful when using the valuation method under s 75-10(3) that the interest held or acquired in real property prior to 1 July 2000 and the subject of a subsequent taxable supply must be a legal interest and not merely an equitable one. Also of importance is the Court's view that the margin scheme can only apply where the property that is acquired or held is the same as the property sold.

The Decision Impact Statement released soon after this decision was handed down, states that while the Commissioner agrees with the Court's decision to uphold the assessments issued, the basis upon which the decision was made is contrary to the Commissioner's submissions and long standing practices in relation to the availability of the margin scheme. The Commissioner has indicated that should the taxpayer appeal the decision, the Commissioner will contend that the appeal be determined on the basis of the submissions made to Federal Court.

The Commissioner has stated that until the outcome of an appeal from the decision of the Federal Court (if any) is known, the Commissioner will maintain the views in its current rulings, GSTR 2000/21, GSTR 2006/7 and GSTR 2006/8. This means that developers and others who rely upon the current rulings to self assess their GST liabilities under the margin scheme will be protected from retrospective adjustments where all other requirements in the *Taxation Administration Act* 1953 (Cth) are satisfied[6].

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Reference notes:

1 *[2008] FCA 81.*

2 *Section 195-1 of GST Act.*

3 *Sterling Guardian Pty Ltd v Federal Commissioner of Taxation [2005] FCA 1166*

4 *Above n 1, at [34].*

5 *Above n 1, at [41].*

6 *Decision Impact Statement dated 20 February 2008.*