



Property Newsletter

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Reliance Carpet case and GST on forfeited deposits

You will recall from our newsflash in late May 2008 that the High Court unanimously held that GST is payable on forfeited deposits.

There seems to have been a number of misconceptions in the marketplace with respect to the effect of this decision and we highlight the following:

- If the vendor is registered for GST purposes and the vendor has entered into a contract as part of an enterprise, then GST is payable on the forfeited deposit (in an amount equivalent to 1/11th of the forfeited amount) regardless of whether the contract relates to the sale of residential or commercial property.
- The fact that the contract states that the margin scheme will be utilised does not affect the amount of GST payable where the deposit is forfeited. In those circumstances GST will still be 1/11th of the forfeited deposit, as the deposit paid is security for the performance of an obligation and this is the taxable supply.

The margin scheme only becomes relevant if the transaction proceeds to completion.

There has been a significant amount of case law over the years which has held that a deposit of more than 10% (which is deemed to be the norm) is a penalty. We do not believe that increasing the deposit to 11% of the purchase price (to cover the GST element if the purchaser defaults and the deposit is forfeited) would constitute a penalty if the reason for this was clearly set out in the contract.

In New South Wales this would mean that the standard contract provision requiring the deposit to be not more than 10% of the purchase price would need to be appropriately amended.

Of course, this may be more problematic where a deposit bond or bank guarantee has been provided rather than a cash deposit but again the issuing insurer company or bank may be able to be convinced that all that a developer is doing is protecting its entitlement to a full 10% deposit (net of GST) if a forfeiture takes place.

If you have any queries as to how the Reliance Carpet case may impact upon your business, please feel free to contact the writer or any other professional staff member of the property group.

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Good GST news for developers

Due to a recent move by the ATO, property developers will be able to reduce the amount of GST they pay as increasing adjustments in situations where new residential premises for sale (and that are actively marketed that way) are temporally leased out due to market conditions.

Division 129: Adjustments

Under Division 129 of the GST Act the need for an adjustment in relation to property development arises in respect of an acquisition where:

- there is a difference between the actual application and the planned (or intended) application of the property for a creditable purpose, or
- there is a difference between the actual application of the property up to the end of one adjustment period and the actual application of the property up to the end of the previous adjustment period.

The need for an adjustment often arises in the following scenario:

1. Acquisitions are made by the developer which is constructing new residential premises with the sole intention being construction for sale.
2. The developer claims an input tax credit in respect

of the acquisitions because at the time they were acquired they were solely for a creditable purpose.

3. Since constructing the new residential premises, the developer has, in a weak selling market, leased the premises until such time as a sale take place.

The ATO's view

The ATO, in its previous communication on the subject ("*Changes in extent of creditable purpose under Division 129*" March 2008), advised that a developer is entitled to 100% input tax credit on its acquisition related to the construction of the premises (provided it did not initially have any intention of renting the premises).

The developer is then required to make a 100% increasing adjustment (to reverse the original input tax credit in full) at the next adjustment period after the premises are first rented - this is despite the fact that the developer still intends to sell the properties in the future.

Once the properties are sold as new residential premises, the developer is entitled to reclaim some of its original credits through a decreasing adjustment.

The ATO's view was supported by the theory that the act of renting

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the premises (despite while trying and having the intention to sell) was applying the acquisitions to a purpose other than that which existed when they were purchased - effectively it was a change in use and purpose.

A new perspective

On 19 August 2008 the ATO published ATO Interpretative Decision (ID) 2008/114.

The interpretative decision ruled that in cases such as that described above, the wording under Division 129, and in particular the use of the word "application", could be appropriately construed to mean that "**actively marketing the premises for sale**" will be evidence of use of the premises that demonstrates that the premises have been applied to **some extent** for the creditable purpose of the sale.

Whilst the ruling is good news for property developers, it does not mean that there is no increasing adjustment but rather the increasing adjustment will need to reflect the **extent** to which the premises have been applied for a creditable purpose (being the sale of the premises) between when the relevant property was acquired and the end of the adjustment period. Simply put, adjustments will need to be calculated with a "fair and

reasonable basis of apportionment" or by using the formulae contained in the provisions of Division 129. Nonetheless, in light of the fact that revenues from any future sale of the property would substantially exceed the rent received prior to the property sale, the new approach should dramatically ease the previously held concerns of developers.

"Actively marketing the premises for sale"

Particular importance should be placed on developers ensuring that residential premises so rented continue to be "actively marketed for sale". As described in the Interpretive Decision, actively marketed for sale can mean a variety of things but generally includes:

- listing the property for sale with a real estate or agents
- advertising the premises for sale in relevant publications or by internet advertising on websites for real property
- arranging open for inspection times and/or showing prospective buyers through the premises.

In the case of strata units, actual arms length sales of some of the listed units would be further evidence of active marketing, while listing premises for sale at a price that is significantly above

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market value maybe an indicator that the premises are not being actively marketed for sale.

Watch this space

Importantly, ATO ID2008/114 does not have the force of an ATO ruling. Whilst it is reasonable to expect the ATO to follow the decision in its own Interpretative Decision, it should be emphasised that it is not law. The ATO has indicated that this revised view will be discussed more fully in a draft GST determination , a paper that should be published in the next two to three months. Of interest the paper may also address the issue as to those developers who have relied upon the views stated in earlier ATO publications, and who have as a result, overpaid GST, and whether they may be entitled to refunds.

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Budget changes to stamp duty

The New South Wales State Budget in May 2008 made a number of changes with regards to duty.

To encourage property investment, the mortgage duty on non-owner occupied residential property was abolished from 1 July 2008.

All mortgage duty will be abolished by 1 July 2009.

Further, the abolition of duty on the transfer of business assets (other than land) has been brought forward from 1 July 2012 to 1 January 2011.

Also, effective from 1 July 2008, no duty is chargeable on a transfer or an agreement for sale or transfer of marketable securities or a land rich acquisition where the Chief Commissioner is satisfied that the transaction is entered into to give effect to a rollover scheme under Subdivision 124-Q of the *Income Tax Assessment Act*.

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Mixed use buildings: enforcement of a prohibition on fast food outlets

Traditional difficulties between owners and occupiers are compounded when one building is established for different uses, such as retail and residential. To allow fair enjoyment of a building by all occupants, it is important that building documents are attentively prepared. Failure to do so may result in disputes that are not only costly, but which may also allow an apparently obvious breach to continue until appropriate court orders are able to be obtained. Such court orders could take a long time.

New South Wales strata laws require a Strata Management Statement (**SMS**) to be registered on building title whenever a strata plan is registered over part of that building. For example, to manage the relationship between an owners corporation of all retail lots and a separate owners corporation of all residential lots.

One recent case relating to the interpretation of a SMS spent more than three years in the New South Wales Supreme Court before it was resolved (*Idya Pty Ltd v Anastasiou* [2008] NSWCA 102).

The relevant premises were in a building that comprised both residential and retail strata units at the Manly beachfront. There was a separate owners corporation for each. An SMS was registered on the title to the building.

By law, an SMS "has effect as an agreement under seal" that applies not only to the owner of a lot in a building, but also to each owners corporation, mortgagee and lessee.

Amongst the provisions of the SMS for the building was one that read:

"The owners of the Retail Shops must not use the Retail Shops as a fast food outlet."

Tenants of a retail unit on the ground floor were operating an Oporto chicken shop.

The Residential Owners Corporation (**Residents**) brought an action to close the Oporto shop down. The Supreme Court agreed the Oporto shop was a "fast food outlet". However, the clause of the SMS that prohibited the retail owners from using the premises as a fast food outlet was expressed to apply only to "the owners". It did not expressly apply to the tenants. So the Residents were unsuccessful in their attempts to close the Oporto shop down.

In a new action, the Residents commenced action against the owners of the shop. The Residents alleged breach of the SMS by the owners by allowing the "use" of the premises as a fast food outlet. The owners argued that their "use"

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of the premises was not as a fast food outlet and that the SMS did not prohibit them from allowing the "use" of the premises as a fast food outlet. The Supreme Court disagreed. The tenants appealed to the Court of Appeal.

Two appeal judges looked at the SMS, and sought a "commercially sensible" reading of the prohibition. They decided the word "use" in the context of the SMS had a meaning that included "permitting to be used." The third judge decided that the word "use" did not itself mean "permit to be used." However, to make sense of the SMS, he decided the Court should imply into the clause an extra phrase, "or permit to be used."

As a result all three appeal judges agreed that the retail owners were in breach of the SMS, and ordered them to not use the premises as a fast food outlet and to take all steps necessary to ensure that the fast food outlet cease to operate.

So what went wrong? Why did it take the Residents 4 years, 6 months and 16 days to get an order presumably effectively stopping the tenants from operating a fast food outlet when the SMS seemed to say that such a use was prohibited?

To use the words of Justice Handley, because the "drafting deficiencies in the SMS provided a foothold for the arguments" of the retail owners and their

tenants so that neither of them could be stopped.

A lot of time and money was expended trying to resolve an issue that a "well drawn covenant" should have quickly resolved.

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Land Tax adjustments

Recent amendments to the *Land Tax Management Act* have been introduced dealing with the principal place of residence exemptions.

The major changes which have been made are to Schedule 1A which deals with the principal place of residence exemption. Also consequential changes have been made to section 10 of the Act.

The new provisions deal with the following:

- (a) An exemption from land tax if the land is the site of a flat that is used as a principal place of residence and there is also situated on the land one or more other lots that are used or adapted for use as a separate occupation to that of

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the owner. This provision does not apply to land comprising one or more strata lots.

- (b) The exemption of two or more lots of land occupied by the owners of the lots as a principal place of residence where the lots are adjoining, the lots are in the same ownership and the lots are the site of a single residence.
- (c) Exemption for two or more strata lots as a principal place of residence where the strata lots have adjoining walls or floors, the strata lots are in the same ownership and they comprise a single residence.

These exemptions add to the already substantial list of exemptions set out in Schedule 1A to the *Land Tax Management Act*.

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