High Court Decision – GST and property leases

4 December 2014

In brief

High Court decision for the Commissioner in the MBI Properties case

Yesterday the High Court unanimously decided to allow the Commissioner's appeal in the MBI Properties case. This decision provides certainty as to whether the new owner of a reversionary interest in real property is required to pay GST on the rent received for the lease of the property, or is potentially subject to an increasing GST adjustment under Division 135 of the GST Act if they acquired the property as a GST-free going concern. Earlier decisions in the Federal Court had concluded that in the context of a lease, there was only one 'supply' for GST purposes being the entry into or the grant of the lease. In overturning these earlier decisions, the High Court has confirmed a supply is made by the new owner of the reversionary interest.

In detail

On 3 December 2014, the High Court handed down its decision in *Commissioner of Taxation v MBI Properties Pty Ltd [2014] HCA 49*. The High Court decided that the taxpayer (MBI) was required to make an increasing adjustment under Division 135 of the GST Act in relation to its GST-free acquisition of a going concern comprising three residential apartments encumbered by lease agreements with MML, an entity managing a serviced apartment complex. The background to this decision is set out below.

- Division 135 of the GST Act provides that the recipient of a GST-free going concern has an increasing adjustment if it intends to make supplies through the enterprise so acquired, other than taxable or GST-free supplies.
- The MBI litigation followed the decision in *South Steyne Hotel Pty Ltd v Commissioner of Taxation [2009] FCAFC 155*, in which the Full Federal Court held, among other things, that the sale of residential apartments subject to lease agreements by South Steyne Hotel Pty Ltd (South Steyne) to MBI were GST-free supplies of going concerns.
- The Full Federal Court, in *MBI Properties Pty Ltd v Commissioner of Taxation [2013] FCAFC 112* held that MBI did not make any supply to MML, and therefore Division 135 had no application. The Full Federal Court's reasoning was that the supply of the leased property occurred when South Steyne granted the lease to MML. Upon acquiring the reversionary interest in the property, MBI did not make any supply (continuous or otherwise) to MML.

- The first issue considered by the High Court in the Commissioner's appeal was whether MBI, as purchaser of the reversionary estate in the leased apartments, made a 'supply' to MML during the remaining term of each lease.
- The High Court considered the nature of executory contracts, and stated that they will generally involve the supplier making at least two supplies – one at the time of entering into the contract, and another at the time of performance. In the case of a lease, this second supply was found to occur progressively throughout the term of the lease, by means of the lessor (MBI) observing and continuing to observe the express or implied covenant of quiet enjoyment under the lease. On this basis, the High Court stated that the Full Federal Court was wrong to conclude that the only relevant supply was the grant of the lease, and found that MBI was making a supply (of input taxed residential premises) following its acquisition of the apartments.
- The second issue in the appeal was whether there was any 'price' for that supply for the purpose of calculating an increasing adjustment under Division 135.
- The High Court's reasoning on this question was brief. However, it rejected MBI's argument that the rent paid to it by MML was exclusively the price for the earlier supply of the grant of the lease. The High Court stated that there is nothing in the definitions of 'price' or 'consideration' in the GST Act "to suggest a need to establish an exclusive connection between a particular payment and a particular supply" in order to avoid double taxation. The High Court expressed the view that it is the attribution rules which ensure that double taxation does not occur. It therefore held that the rent paid to MBI was the price for MBI's supply to MML.

The High Court concluded that the conditions for the operation of the Division 135 increasing adjustment provisions were met, and the Commissioner was correct to assess MBI for an increasing adjustment under that Division.

The takeaway

The decision of the High Court essentially restores what was the generally accepted view of the GST consequences of the supplies made under a lease and the operation of the GST adjustment provisions. That is, GST will continue to be payable by a new lessor even where they did not enter into the lease with the lessee. Further, the new lessor may have an increasing GST adjustment where it acquired a leasing enterprise as a GST-free going concern but subsequently make input taxed supplies of residential premises.

If you are about to acquire residential premises as part of a GST-free going concern, you should carefully consider whether the GST adjustment provisions will apply to you once the transaction is concluded. Further, if you have already acquired residential premises in this way and have not made an increasing adjustment under Division 135, you should review your circumstances to establish whether you may be required to pay an amount to the ATO.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Peter Konidaris
+61 (3) 8603 1168
peter.konidaris@au.pwc.com

Denis McCarthy, Sydney
+61 (2) 8266 3028
denis.mccarthy@au.pwc.com

Michelle Tremain, Perth
Tel: +61 (8) 9238 3403
michelle.tremain@au.pwc.com