

GST & forfeited deposits - High Court decision

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In the recent decision of *FC of T v Reliance Carpet Co Pty Ltd* [2008] HCA 22, the High Court unanimously held that GST applies to a deposit forfeited to a vendor where a purchaser defaults under a contract for the sale of land, in Victoria. Eight years after its introduction, this is the first decision of the High Court on the GST. In this article, we examine the High Court's decision, focusing, in particular, on the implications of the decision for the standard NSW sale of land contract.

Background

Facts

In simplified terms, in January 2002, the vendor (**taxpayer**) entered into a contract for the sale of land, in Victoria, with a purchaser. The purchase price for the sale of property was \$2,975,000. The deposit under the contract was \$297,500, payable at exchange with the balance of the purchase price payable at settlement 12 months later (subsequently extended to 18 months). The sale was not a supply of a going concern.

At settlement, the purchaser failed to pay the balance of the purchase price and, after the taxpayer provided a notice to complete, the purchaser again defaulted. The taxpayer thus terminated the contract. As a result, the purchaser forfeited their deposit to the vendor. The Commissioner assessed the taxpayer as liable to GST on the forfeited deposit. The taxpayer challenged the Commissioner's assessment.

Earlier decisions

At first instance, before the Administrative Appeals Tribunal, the taxpayer failed. The Tribunal held that the deposit should be treated as consideration for a supply attributable to the tax period in which the deposit was forfeited.

The taxpayer then appealed to the Full Federal Court and succeeded. Before the Federal Court, the taxpayer argued that there was no supply for which the forfeited deposit could be consideration as the supply of real property did not occur due to the contract being terminated. The Court agreed, holding that there was no supply upon the termination of the contract and hence the payment of the deposit could not be treated as consideration for any supply. Moreover, the Court indicated that section 99-5 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (**GST Act**) did not deem there to be a supply in the circumstances.

The Commissioner then appealed to the High Court. Before the High Court, the Commissioner argued that the forfeited deposit should be treated as consideration for a supply. The Commissioner identified the “supply” as follows:

- a supply of the vendor’s obligations and rights under the contract prior to termination (*interim obligations*);
- a supply of the vendor’s rights arising from termination (*termination rights*); or
- a supply which resulted by reason of the deeming in Division 99 of the GST Act (*supply upon forfeiture of deposit*).

High Court decision

The High Court handed down a unanimous decision in favour of the Commissioner. In giving its judgment, the High Court had to decide two main issues, as follows:

- whether the taxpayer had made a “supply”; and
- whether a deposit forfeited to a vendor, where a purchaser defaults under a contract for sale of property, constitutes “consideration” for a supply (paragraph 1).

Before examining the above two issues, however, the High Court considered first the following two preliminary issues:

- the meaning of the concepts of “rescission” and “termination” as used in contract law; and
- the meaning of the term “deposit” and the legal implications of its forfeiture.

Termination and rescission

Before reaching its decision, the High Court drew a distinction between two commonly misused concepts in contract law – ie rescission and termination. The term “rescission” according to its technical legal meaning refers to an annulment of a contract from the outset (ie *ab initio*). Whereas, a “termination” refers to an ending of a contract, at the election of one party for the breach of another, from the time the election is made (paragraph 2).

On the facts before the Court, what took place was a termination, not a rescission. In the case of a rescission, a contract is never formed and the parties are simply reverted to their pre-contractual positions.

Deposit

The Court then analysed the ordinary meaning of the expression “deposit” as developed in case law and in conveyancing practise (with particular reference to the *Property Law Act 1958 (Vic) (Act)*).

In particular, the High Court noted that the concept of a deposit has several aspects of relevance to forfeiture, as follows:

- the deposit would have counted towards the purchase price had the contract proceeded to completion;
- if specific performance had been sought but refused, the Supreme Court would have had the power under section 49(2) of the Act, to order the repayment of the deposit and leave the taxpayer to recover damages, if applicable;
- if the contract had been terminated for breach, the deposit would be taken into account in the assessment of damages, if an action were pursued against the purchaser;
- the deposit was provided by the purchaser to the taxpayer as ‘an earnest to bind the bargain’ of the contract; and

- the deposit provided to the taxpayer a form of security for the performance by the purchaser if the contract remained executory, but uncompleted (paragraphs 23 to 26).

Having regard to the above principles on deposits, the Court concluded that it would be sufficient for the Commissioner to prove his case, if he could show that the presence of one or more of the characteristics of a forfeited deposit satisfied the “consideration” requirement of a “taxable supply”. On the facts before the Court, the deposit operated as security for the performance of the obligation of the purchaser to complete the contract and was liable to forfeiture if completion did not occur (paragraph 28). The Court thus rejected the taxpayer’s contention that the deposit forfeited to the vendor was in the nature of damages with no resulting supply (paragraph 24).

The Court then noted that any of the following three events can happen to a deposit in a conveyancing transaction:

- 1) upon termination by the vendor for breach by the purchaser, the vendor can be entitled to the deposit, as a result of its forfeiture;
- 2) upon termination by the purchaser for breach by the vendor, the purchaser can be entitled to a repayment of the deposit; or
- 3) upon completion of the contract, the deposit can be applied towards the purchase price.

The liability to GST upon a deposit depends upon whether one or other of the events referred to in section 99-5 of the GST Act has occurred (paragraph 35).

Having distinguished the concepts of rescission and termination, and analysed the meaning of the expression deposit, the Court then examined whether a “supply for consideration” had been made.

Supply

On whether there was a supply, the High Court held that upon execution of the contract, the vendor entered into an obligation to do the things it was bound to do under the contract, such as maintaining the property in its present condition, paying rates, taxes and other outgoings. Thus, the vendor made a supply to the

purchaser within section 9-10(2)(g) of the GST Act. That is, it entered into an obligation to do something.

Also, upon exchange of contracts, the taxpayer granted to the purchaser contractual rights exercisable over or in relation to the land. In particular, the vendor granted to the purchaser the right to require, in due course, the conveyance of the land to it upon completion. Again, this involved the vendor making a supply to the purchaser within section 9-10(2)(d) of the GST Act (paragraphs 37 and 38). That is, it granted real property or an interest in real property.

However, in this respect, the Court's decision seems to be limited to a termination for breach by the purchaser, as opposed to a rescission. If a contract is rescinded, then the contract between the parties is annulled and the issue thus arises, as to whether despite the absence of a contract there can still be a supply.

Consideration

On the consideration issue, the High Court held that the payment of the deposit was 'in connection' with a supply (section 9-15(1)(a) of the GST Act). However, the deposit could not be treated as "consideration" for a "supply" unless the deposit was forfeited as a result of the purchaser's failure to perform its obligation under the contract (section 99-5(1) of the GST Act).

On the facts, the taxpayer was entitled to terminate the contract due to a breach by the purchaser and the deposit was thus forfeited to the taxpayer. Therefore, the forfeited deposit was "consideration" for a supply as required by section 99-5(1) of the GST Act (paragraphs 33 and 34).

Taxable supply

Accordingly, the Court held that upon forfeiture of the deposit, by reason of the failure of the purchaser to complete the contract, the making of the contract (ie the "supply") became a "taxable supply" (section 9-5 of the GST Act) (paragraph 40).

In so concluding, the Court indicated that, upon a proper construction of the GST Act, no two “taxable supplies” arose. That is, the making of the contract (first “taxable supply”) and a supply deemed by the operation of Division 99 of the GST (second “taxable supply”).

Where the sale proceeds from contract to completion, the deposit will generally be applied as part of the purchase price. If and when that happens, the deposit will be applied as part of the consideration for the transfer of land and GST will be attributable to the tax period in which this happens. Notably, that will be the time that the only taxable supply will be made (paragraph 42).

Implications of High Court decision for NSW contract of sale

In the NSW standard contract for the sale of land (2005 edition) (**NSW Contract**), the terms ‘rescind’ and ‘terminate’ are expressly defined. ‘Rescind’ means rescind the contract from the beginning and ‘terminate’ means terminate the contract for breach (clause 1 of the NSW Contract).

Termination

The High Court’s decision would appear to apply to a termination of the NSW Contract by a vendor for a breach by a purchaser, assuming all of the requirements of a “taxable supply” are met by the vendor. The position regarding terminations in Victoria and NSW would appear to be sufficiently similar, such that the reasoning of the High Court can be said to apply equally to a deposit forfeited for termination in NSW, as in Victoria.

Rescission

Under general law, if the NSW Contract is rescinded, however, the effect of the rescission will be to restore the vendor and the purchaser to their pre-contractual positions, as if the contract was never entered into.

From the High Court’s analysis, it is arguable that in the case of a rescission, a “supply” does not arise as the NSW Contract is completely annulled (ie the contract is taken never to have existed). However, upon a proper analysis of the

High Court's reasoning, there may still be a "supply" by the vendor to the purchaser, even in the case of a rescission, despite the lack of the NSW Contract.

In general, in the case of a rescission, the position of the parties is determined by the common law and also by the following:

- the provisions of the NSW Contract. In particular, clause 19 of the Contract and any special conditions varying the standard terms; and
- statutory provisions governing such rescissions.

Express provisions in NSW Contract

If clause 19 survives a rescission of a NSW Contract or it is varied by a special condition such that it does not provide for a refund of the deposit to the purchaser (ie the deposit is effectively forfeited), then if a rescission takes place, a supply may arise. In particular, a "supply" may arise where the vendor creates a right to enter into contractual relations with the purchaser or is obliged to enter into a NSW Contract with the purchaser (sections 9-10(e) and 9-10(g)(i) of the GST Act).

Alternatively, if the purchaser is put in possession prior to rescission, the vendor will be entitled to a reasonable adjustment from the purchaser. In such a case, the purchaser in possession will have to make a payment to the vendor as a result of the use of the property. In both instances, the issue arises:

- whether there is a "supply" by the vendor, as the NSW Contract is annulled; and
- whether the forfeiture of the deposit or the payment of a reasonable adjustment constitutes "consideration" for a "supply".

Is there a supply?

The meaning of the term "supply" in the GST Act is quite broad and may include the position where a vendor creates a right to enter into contractual relations with a purchaser. As rescission treats the NSW Contract as annulled, it would seem that a Court or the ATO, to find a supply, will need to look at the obligations or promises of the parties prior to the entry of the Contract or outside of the terms stated in the Contract. Despite this inquiry, however, given the width of the concept of a supply, it may be that a supply can nevertheless still be found.

Is there consideration?

However, whether a forfeited deposit will constitute "consideration" for a supply depends on whether the deposit is forfeited because of a failure to perform an obligation. In the case of a rescission, the relevant obligation could simply be the requirement to actually have a contract, as opposed to performing a contract that exists. Since, in the case of a rescission, a contract is considered to not exist, the deposit is forfeited due to the lack of a contract not being formed.

In the case of a reasonable adjustment, it is arguable that a payment made will constitute "consideration" as it is made 'in connection' with a supply (ie the taking of possession of real property) (section 9-15 of the GST Act). Like any other payment for a licence or a lease over land, such an adjustment would appear to be 'in connection' with a supply of an interest in land or a right over land.

If all of the other requirements of a taxable supply are also met, both forms of supply may thus result in a 'taxable supply' (section 9-5 of the GST Act). Accordingly, any deposit forfeited to a vendor or the payment of a reasonable adjustment may both be liable to GST.

Statutory provisions governing rescission

Under section 66V of the *Conveyancing Act 1919* (NSW), a purchaser must forfeit 0.25% of the purchase price to the vendor where the purchaser exercises a right to rescind under the cooling-off provisions. In respect of this deposit, and its forfeiture, similar issues arise to those considered by the High Court in its decision - ie whether the "deposit forfeited" is "consideration" for a "supply".

Is there a supply?

Following the High Court's reasoning, it would seem that the better view is that the vendor does make a "supply", prior to entering into the NSW Contract, by surrendering their right to sell the property or being obliged to refrain from selling the property (sections 9-10(e) and 9-10(g) of the GST Act).

Is there consideration?

If the “deposit forfeited” is security for the performance of an obligation by the purchaser, the “deposit” may be “consideration” for a supply as payment could be made as part or all of the consideration for the vendor’s “supply” (section 99-5 of the GST Act).

Alternatively, the deposit may simply be payment ‘in connection’ with the vendor’s supply (ie the temporary surrender of their right to sell property), rather than a security for the performance of an obligation. In that case, the payment will be “consideration” for a supply within section 9-15 of the GST Act, rather than within section 99-5 of the GST Act.

If all of the other requirements of a taxable supply are also met, the supply made will be a ‘taxable supply’ (section 9-5 of the GST Act). Thus, the deposit forfeited to the vendor, in the event of a rescission under section 66V, may be liable to GST.

Holding deposits

Although the High Court does not consider the GST implications of forfeited **holding** deposits, it could be that the reasoning of the Court may also extend to such forfeited deposits.

Holding deposits are deposits paid by a potential purchaser to a vendor to ‘hold’ the property for the potential purchaser. However, holding deposits have no real legal effect as no contract for sale, at the time of payment of such a deposit, has actually been entered into between the parties.

Is there a supply and consideration for the supply?

Applying the High Court’s reasoning, it is arguable that upon the payment of the holding deposit, the vendor enters into an obligation to hold the property for the potential purchaser (ie a “supply”) and the holding deposit is held as security for

the purchaser to perform their obligation (ie to enter into contractual relations with the vendor). In such cases, therefore, the payment of the holding deposit may be viewed as made 'in connection' with a supply (section 9-15 of the GST Act).

However, the holding deposit will not be "consideration" for the supply unless the holding deposit is forfeited for failure of the potential purchaser to perform their obligation (section 99-5 of the GST Act). That is, the potential purchaser fails to enter into contractual relations with the vendor. As such, if all of the other requirements of a taxable supply are met, in a case of a forfeiture of a holding deposit, the forfeited deposit to the vendor may be liable to GST.

Conclusion

On its facts, the High Court's decision appears to be correct, representing an application of general principles relating to supplies in the GST law. The High Court's decision would have been more interesting if it had dealt with a rescission, rather than a termination. The lack of commentary by the High Court on the GST implications of a rescission could mean that the decision is potentially of narrow application. However, by simply applying the Court's reasoning, it would seem that a taxable supply can arise in the context of terminations and rescissions alike. Ultimately though, the extent of the application of the High Court's decision remains to be seen.