

ANGST UPDATE

MARGIN METHOD MAYHEM

On 17th March 2005 a new Bill was introduced into Parliament that makes significant changes to the operation of the margin scheme under the GST provisions. These changes will have a dramatic effect on how this GST concession is applied into the future. More importantly, in its current form, the proposed legislation will result in some taxpayers suffering a significant loss if they acquired existing property holdings GST-free since 1st July 2000. As this bill is not yet law, it is important that all taxpayers become familiar with these proposed changes and their financial impact. Where they are adversely affected, they should immediately lobby the Government to make their views known before these changes take effect. As the law is likely to be passed by Parliament in the May budget sittings, there is no time to lose.

We have set out below a summary of some of these proposed changes and their potential impact.

1. VENDOR AND PURCHASER MUST AGREE TO USE THE MARGIN METHOD FOR IT TO APPLY.

The current position

Currently, the vendor has the choice to apply the margin method to any supply he makes provided the property was not acquired by him as a full taxable supply. Unless the purchaser negotiated that the margin method was to apply, they technically had no choice in the matter. This led to some hardship cases where the purchaser thought they were buying real property as a full taxable supply and could therefore recover the GST on the purchase, only to subsequently discover that the vendor had applied the margin method. Not only were they not able to recover the GST on the acquisition, but they may have paid too much for the real property as a result.

The proposed change

To rectify this, the new Bill will require both the vendor and the purchaser to agree to use the margin method. This change will be effective from the date the Bill is assented into law presumably sometime in May. Whilst the agreement to use the margin method does not need to form part of the contract, prudence dictates that it will become a clause of the contract.

We agree in principal with this change as it will assist in protecting purchasers. However we note that well informed purchasers will ensure the contract stipulates that the supply is a full taxable supply and not make this mistake.



EDITOR – TONY EVANS

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GuSTAX Consulting Pty Ltd
ABN 16 097 171 509
(Just Tax Consulting)
 PO Box 5200, Studfield Post Office,
 Wantirna Vic. 3152
Email: tony@justtax.com.au

“Angst Update” is a registered business name in the State of Victoria.

About the Editor

Tony Evans is a Chartered Accountant who has extensive tax consulting experience over 25 years working in the profession including overseas experience working with VAT in the UK. The founder and Managing Director of GuSTAX Consulting Pty Ltd, he was previously a partner with a boutique tax division in one of the mid-tier accounting firms in Melbourne. Tony's diverse tax specialisation's include: -

- GST
- Employment taxes
- Corporate Taxes
- CGT
- PAYG
- Expatriate Taxation

He is also recognised as an excellent communicator and trainer and has conducted numerous technical sessions for the ICAA and members of the profession. ♦

We query the need to make this change as it only seeks to protect the position of uninformed or poorly advised purchasers.

However, this change, in its proposed form, will potentially have a dramatic impact on contracts signed prior to the time this legislation was announced but which settle after the date this law is assented. This will affect many recently signed contracts as well as many off-the-plan sales as the following example demonstrates.

Example

Roger has signed a contract to sell Peter a block of land for \$106,000 on 1st March 2005. The sale is to settle on 30th June 2005. He acquired the land for \$40,000 from an unregistered supplier on 1st October, 2000. Although the contract does not stipulate that the margin method was to be used, it was always his intention to use this method in working out his GST liability. Had the margin method been applied, Roger's GST liability would be \$6,000 (1/11th of [\$106,000 - \$40,000]). This is a good thing for Roger as his sub-division costs (net of GST) were \$58,000, resulting in an estimated profit after GST is \$2,000.

Let us assume that the proposed legislation changes become law on 1st June 2005. Peter had been verbally informed that the margin method was to be applied. He had reconciled himself to the fact that the land was going to cost him \$106,000 without a GST recovery even though this was not spelt out in the contract. As he is going to develop this land he decides he would like to get an input tax credit after all on the purchase. He refuses to give his written agreement to Roger to allow Roger to apply

the margin method.

As a result, Roger can no longer apply the margin method. His GST liability is now 1/11th of \$106,000 or \$9,636.36. He is now making a loss on this block of land of \$1,636.36. Instead of the land costing Peter \$106,000, this land has now cost him \$96,363.64 net of GST recovered. He has made a windfall gain purely due to this legislation.

Recommendation

If the Government is to persist with this change, there should be a transitional rule where any contract for the sale of real property that is signed before 17th March 2005 will apply the old rules regardless of when the contract actually settles. In this way, the status quo on open transactions will remain in place.

On the basis of "buyer beware", we see no need for this change. Where vendors wish to apply the margin method in the future, they will be forced to incorporate a clause into the contract that stipulates that the vendor and purchaser agree that the margin method should apply. If the purchaser really wants the real property, they will sign and agree. This law change is unlikely to promote choice, but it will just make contracts more certain.

Whilst we sympathise with purchasers caught out in the past, this law change is designed to protect the purchaser's ignorance and to protect incompetent advisors involved in these contracts. It is not a good basis for changing the law.

2. NEW MARGIN METHOD RULE FOR GST-FREE REAL PROPERTY ACQUISITIONS

The current position

The second change effectively robs certain property developers of part (or in some cases all) of their legitimate profits in relation to developments in progress when this legislation was introduced.

The margin method is available for use where real property has **not** been acquired as a full taxable supply. Therefore real property acquired GST-free as a going concern is eligible for re-sale under the margin method. Real property could be legitimately acquired GST-free by applying the going concern provisions or acquiring

DETAILS	METHOD OF SALE		
	FULL TAXABLE	MARGIN	GST-FREE
Gross Acquisition Cost	1,100,000	1,090,000	1,000,000
Recoverable GST	100,000	-	-
Net Acquisition cost	1,000,000	1,090,000	1,000,000
Development Costs (Net of GST)	1,500,000	1,500,000	1,500,000
Margin	N/A	1,660,000	1,750,000
Gross Sale proceeds	2,750,000	2,750,000	2,750,000
GST Remitted	250,000	150,909	159,091
Net Proceeds	2,500,000	2,599,091	2,590,909
Profit from Development	-	9,091	90,909

GST-free farm land. It should be noted from that where a purchaser acquired real property GST-free, significant anti-avoidance rules are in place which will assess GST on the purchaser where it is not subsequently used for full creditable purpose.

It became common and acceptable practice for property developers to acquire real property for development GST-free wherever possible and as long as the GST-free provisions were met. There were several reasons for this approach. Firstly, it minimised the base on which stamp duty was payable in relation to the acquisition of the property. As shown in the above table, stamp duty is payable on a \$1 million acquisition price under the going concern situation rather than \$1,090,000 under the margin method and \$1,100,000 as a full taxable supply.

The second reason for this approach was that it maximised the potential profit of the developer, as shown above.

Example

Let us assume that a developer can purchase land for development for \$1 million plus GST if applicable. He can buy it as a full taxable supply (\$1,100,000), as a margin method supply (\$1,090,000) or as a GST-free supply (\$1,000,000). Let us assume that the going concern provisions can be met in full.

Subsequently the developer incurs development costs net of GST of \$1,500,000 and sells all of the developed land for \$2,750,000 GST inclusive. The table on the previous page shows the different overall profit positions that would arise depending on which method is used to buy the property and also assuming that the margin method is used in selling the property where it is available.

Clearly the best approach is to buy as a going concern as it maximises the profit on the development. By acquiring the property as a going concern rather than under the margin method, the profit is increased by \$81,818 plus any stamp duty savings.

The Law Change

From 17th March 2005, taxpayers who acquire real property GST-free after 30th June 2000 can still use the margin method. However, instead of using the consideration they paid for the property as the base of their calculation, they will be required to use the market value of the land as at 1st July 2000. This will ensure that GST is payable on the increment in value of the land since GST commenced rather than on the value added by the developer. The second part of the example demonstrates this.

Example (continued)

Let us assume that the same developer had not sold any of the land acquired in the development stated earlier before 17th March 2005. Now the new margin method rules mean that the margin is calculated with regard to the value of the land at 1st July 2000. Assuming it was only worth \$100,000, the options set out in the table are now available to the developer.

DETAILS	METHOD OF SALE		
	FULL TAXABLE	MARGIN	GST-FREE
Gross Acquisition Cost	1,100,000	1,090,000	1,000,000
Recoverable GST	100,000	-	-
Net Acquisition cost	1,000,000	1,090,000	1,000,000
Development Costs (Net of GST)	1,500,000	1,500,000	1,500,000
Margin	N/A	1,660,000	2,650,000
Margin Method Valuation - 1st July 2000	N/A	100,000	100,000
New Gross Sale proceeds	2,750,000	2,750,000	2,750,000
GST Remitted	250,000	150,909	240,909
Net Proceeds	2,500,000	2,599,091	2,509,091
New Profit from Development	-	9,091	9,091

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Telephone	9884 1187
Facsimile	9887 5325
Email	tony@justtax.com.au

Acquiring the land as a full taxable supply results in no change in position of the developer. However, in relation to residential property developments, it is preferable to minimise the GST by using the margin method as the ultimate buyer cannot recover this GST. Similarly, had the developer used the margin method, they will make an identical profit compared to before. The problem arises where the property was acquired as a GST-free acquisition. In this case, as the margin method is calculated with regard to a much lower figure, the profit has been significantly reduced from \$90,909 to \$9,091. This additional GST is on the value added to the property from 1st July 2000 till the date of purchase from the previous owners of the property.

Why is the law being changed!

Basically, Treasury and the ATO have suddenly realised that there is a permanent loss of revenue where the property is acquired GST-free and sold under the margin method. The initial holder does not pay GST on the value they added to the property whilst they held it. The property developer only pays GST on the value they subsequently add to the property. The change results in the property developer paying GST on the value they added to the property plus the value the previous holder added to the property as well. This is clearly inequitable for the second holder of the property.

The clear implication of the change in the law is that taxpayers that used this opportunity were cheating the taxation system. Why else would the change be made unless the ATO felt they were missing out on revenue due to an abuse of a tax technicality! Had the ATO indicated in their announcements that they considered this

practice unacceptable and put taxpayers on notice not to avail themselves of this opportunity, we could understand

this law change and the approach taken in making this law change. However, this law change was introduced into Parliament unheralded and with immediate effect from the date introduced.

The ATO were well aware of this practice and provided no warnings indicating it was unacceptable. In fact they have released favourable private rulings to some of our clients (amongst many others) confirming that the purchase of land was a GST-free acquisition knowing full well that it was being acquired that way to take advantage of this opportunity. Nothing was said at the time to defer this approach!

Transitional risk

Many property developments take considerable time to complete. We are aware of several developments which were costed on the basis that the property was acquired GST-free thus allowing a further profit margin. In some cases, the decision to proceed with the purchase of the land depended on the additional profit arising from the use of the going concern on purchase as well as the associated stamp duty savings.

As this law change is planned to be effective from 17th March 2005, any developer still holding real property acquired GST-free will now be subject to these rules. Suddenly they are being penalised with retrospective effect. As the price of land is driven by market forces, they cannot pass on this extra tax impost forced on them. In a lot of cases, most of the land may be sold off-the-plan already making it impossible to pass on this impost even if they could justify a higher price. A much fairer approach would be to make the new rules apply only to real property acquisitions made GST-free after 17th March 2005.

With interest rates increasing, and the economy appearing to tighten, the property market is already starting to feel the pressure. Property developers facing potentially smaller margins will now need to consider this additional impost. This law change may be the difference between making a profit and making a loss on some developments and could conceivably send some developers to the wall.

What is of greater concern is the apparent slur on taxpayers who legitimately used the tax rules to their best possible advantage! The approach taken by the Government suggests that these arrangements are a blatant attempt

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by these taxpayers to avoid tax. If this arrangement was so unacceptable to be outlawed with some retrospective effect, why didn't the ATO publish warnings such as a taxpayer alert etc.! More importantly if this is a scheme to avoid GST, then why isn't the ATO applying the GST anti-avoidance provisions in Division 165. We can say with authority that many respectable taxation specialists were confirming the legitimacy and viability of these arrangements which are (in our view) in the realm of acceptable taxation planning rather than taxation avoidance.

Other Problems

Other significant problems arise from this change. As the real property will not be owned by the person requiring the valuation as at 1st July 2000, it will be difficult for them to obtain an appropriate valuation as of that date. In fact, the real property may have passed through the hands of several owners during the period and may have been significantly altered between the 1st July 2000 and the date acquired by the taxpayer GST-free. Without knowing the full facts of the property as at 1st July 2000, an accurate valuation is not possible.

The second problem arises where the land was not used in an enterprise as at 1st July 2000 and only commenced being used in an enterprise subsequent to this date. In these situations, GST should only apply from the date the property was first used in an enterprise and the margin method rules currently allow for this where the first GST registration occurs at that later time. However this change will require the valuation to be back-dated to 1st July 2000 and not to the later time when it was first used in an enterprise.

Recommendation

We strongly recommend that all affected taxpayers immediately contact the Treasurer with regard to this particular change and inform him of their objections. At the very least we would hope that lobbying may allow an exclusion from this rule for land holdings as at 17th March 2005.

3. OTHER MARGIN METHOD CHANGES

The new provisions include other changes to the operation of the margin method. These include:-

- Special rules for property inherited from deceased estates.
- Special rules to allow the market value deeming rules to apply to margin method transactions between associates.
- Changes to ensure that the joint venture and grouping rules cannot be used to avoid GST on real property.
- Allowing the margin method to be used to amalgamated property where part of the property was eligible for use of the margin method and part was not. To use this concession, input tax credits claimed on the ineligible property would need to be refunded.
- Confirming precisely what is meant by the consideration for the acquisition of property for the purposes of applying the margin method.
- Ensuring that only costs actually paid can be taken into account in applying the margin scheme.

Many of these changes are reasonable and do not include adverse consequences. They are, in some cases, shutting down real tax avoidance arrangements. We would be happy to provide more details on these changes upon request – please contact our office for more information ♦.

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