

GST and unimproved land

1. Introduction

- 1.1 Certain provisions in the *A New Tax System (Goods and Services Tax) Act 1999 (Cth)* ("GST Act") allow for concessional GST treatment for supplies by the Commonwealth, a State or a Territory (broadly defined) in respect of land on which there are no 'improvements' at a particular point in time (referred to as 'unimproved land'). These concessional GST provisions are sections 38-445, 38-450 and item 4 of the table in subsection 75-10(3) of GST Act ("Item 4"). Eligibility to apply these concessional GST provisions may mean that the supply is *GST-free* or have the effect that the margin for the supply (that is subject to GST) is reduced when applying the margin scheme.
- 1.2 The word 'improvements' is not defined in the GST Act and the ordinary usage of the word does not carry any fixed meaning. To assist taxpayers, the ATO has issued GSTR 2006/6, which provides guidance on the meaning of the phrase 'land on which there are no improvements'. Several government entities have raised issues with the ATO's interpretation. The situation is somewhat more complicated by the fact that the GST in dispute is notional GST, and therefore cannot necessarily be resolved by the Administrative Appeals Tribunal ("AAT") or the Courts. The ATO has since sought to resolve the issue through a managed alternative dispute resolution ("ADR") process. This paper considers the impact of the first ADR decision and the effectiveness of the ADR process as a whole.

2. Background

Supplies under sections 38-445 or 38-450

- 2.1 Whether there are improvements on the land is relevant to establishing whether a supply made by the Commonwealth, a State or a Territory is *GST-free* under sections 38-445 or 38-450 of the GST Act. Under section 38-445, if the Commonwealth, a State or a Territory makes a supply of land on which there are no improvements and the supply is of a freehold interest or long-term lease, it is *GST-free*, provided that the land has not previously been supplied as a *GST-free* supply under section 38-445. Under section 38-450, a supply by the Commonwealth, a State or a Territory of land on which there are no improvements is *GST-free* if the supply is by way of a lease, other than a long-term lease, and the lease is subject to conditions that when satisfied entitle the recipient to the grant of a freehold interest in or long-term lease of the land. (The subsequent supply of the freehold interest or long-term lease being *GST-free* in accordance with section 38-445.)

Supplies under subsection 75-10(3)

- 2.2 Whether there are improvements on the land is also relevant if a taxable supply of real property is to be made under the margin scheme, and the margin for the supply is to be calculated under subsection 75-10(3) of the GST Act. Whether there are improvements on the land will determine which item in that table in subsection 75-10(3) applies to the supply. The applicable item in the table then establishes the valuation date to be used in calculating the margin. Where the supplier is the Commonwealth, a State or a Territory, who has held the interest since before 1 July 2000, and there were no improvements on the land as at 1 July 2000 then Item 4 applies. Under Item 4, the margin for the difference between the consideration for the supply and an approved valuation of the interest on the day of settlement.

Commonwealth, a State or a Territory

- 2.3 The words 'Commonwealth', 'a State' or 'a Territory' are not limited to a specific government entity but encompass all the departments and agencies that fall within the ambit of the term (see GSTR 2006/5).

Significance of the GST Unimproved Land Concessions

- 2.4 Although eligibility to apply the GST concession is limited to government entities, supplies under the concessions can provide both a public and private benefit (particularly in relation to subsequent supplies under the margin scheme). The GST unimproved land concessions can be

hugely lucrative (more so than other GST concessions) with potential for both GST and stamp duty savings. For this reason, great weight is placed on whether land is unimproved.

3. Old Meaning of 'Improvement'

GSTR 2006/6

- 3.1 In considering the meaning of 'improvements', the Commissioner relies on the High Court decision in *Morrison v Federal Commissioner of Land Tax* (1914) 17 CLR 498 (**Morrison**) where the Court held that improvements, in the context of land tax, to be:¹

Any operation of man on land which has the effect of enhancing its value comes within the definition of 'improvement'.

- 3.2 In applying this principle, in the Commissioner's view in GSTR 2006/6, for there to be 'improvements' on the land:

- (a) there must have been some human intervention;
- (b) the human intervention must have been physically located on the land; and
- (c) the human intervention must enhance the value of the land at the relevant date for ascertaining whether there are improvements on the land.²

- 3.3 To determine whether there has been some human intervention, the Commissioner employs the concept of the 'natural state' of the land. That is, to establish whether there are human interventions and possibly improvements on the land, the land is compared with that land in its hypothetical 'natural state'. This has raised its own evidentiary issues for taxpayers, who are required to establish a good 'base-line' for determining the 'natural state' of the land.

- 3.4 GSTR 2006/6 provides that notwithstanding that a human intervention may be on the land, it may not necessarily be an improvement; to be an improvement, the human intervention must *enhance* the value of the land (the 'value' approach).³ Determining whether a particular human intervention on the land increases the value of the land is an *objective test* based on the facts of a particular case. On that basis, whether an intervention enhances the value of the land is not to be determined by reference to use or intended use by either the supplier or the recipient of the land.

- 3.5 The Commissioner also considers when an improvement may be 'exhausted', that is, an improvement that once enhanced the value of the land no longer enhances the value of the land, and the circumstances when this may occur. The Commissioner accepts that where improvements on the land have deteriorated over time or have contributed to land degradation, those interventions may no longer enhance the value of the land and may therefore no longer be improvements.⁴ To provide support for the fact that human interventions that once enhanced the value of the land may be exhausted the Commissioner refers to two High Court cases, being *Morrison*⁵ and *Lewis Kiddle and another v Deputy Federal Commissioner of Land Tax* (1920) 27 CLR 316. Determining when something has become completely exhausted raises its own issues for the taxpayer. For instance, has the improvement that an human intervention confers been exhausted when that human intervention is decommissioned? The cost of repair exceeds replacement? Or only when the human intervention is removed from the land?

Disputes in relation GSTR 2006/6

- 3.6 The ATO noted an increase in private ruling, refunds and refund notifications in relation to certain supplies of unimproved land by government entities, and considered that some positions being adopted by government entities were not consistent with the Commissioner's views in GSTR 2006/6.
- 3.7 Significantly, the GST in dispute is *notional GST*. That is, the GST is not imposed under the GST Act (due to constitutional limitations), but rather is imposed pursuant to the Intergovernmental

¹ *Morrison v Federal Commissioner of Land Tax* (1914) 17 CLR 498, 503 ("**Morrison**").

² Goods and Services Tax GSTR 2006/6: 'Goods and services tax: improvements on the land for the purposes of Subdivision 38-N and Division 75' (**GSTR 2006/6**) para 22.

³ *Ibid* para 23.

⁴ *Ibid* 28.

⁵ *Morrison* 504.

Agreement on Financial Relations whereby the States have agreed to pay an amount of notional GST with respect to supplies of land. The Commissioner does not have the power to issue Notices of Assessment to government entities with respect to perceived notional GST shortfalls under the *Taxation Administration Act 1953* (Cth). The ATO position is that rights of review of an ATO decision by the AAT or Courts can only occur whether the disputes relates to an actual liability and therefore cannot occur in respect of a notional liability. The solution proposed to resolve the disputes between the States and the ATO was a managed ADR process. The ADR process that was initially agreed to, on or around 26 November 2013, involved a process similar to (some) litigation where the ATO would look to progress a small number of lead cases.

4. New meaning of 'improvement'

Managed Alternative Dispute Resolution Process

- 4.1 In an attempt to resolve the ongoing disputes, the States and the ATO agreed to an ADR process where, subject to the particular circumstances of the dispute, the government entity and the ATO jointly engaged a neutral evaluator to provide a considered opinion on the issues in dispute. The ADR process was engaged once it was clear that the parties were in dispute about a position reached by the ATO.

First ADR Decision

- 4.2 On 15 April 2015, former Federal Court judge Raymond Finkelstein QC delivered his neutral evaluation ('Evaluation') regarding a dispute between the seller and purchaser of land and the Commissioner. In consideration was whether the supply by the government entity of three sites, which had previously been used for government activities, qualified as GST-free supplies of 'unimproved land' under section 38-445 of the GST Act.
- 4.3 The government entity sold the land to the purchaser, who intended to redevelop the sites for residential purposes. The three sites were sold with existing structures, facilities, connections to utilities and areas without trees (i.e. grassed areas). A certified valuer retained by the government entity formed the opinion that these were not 'improvements' because they would not enhance the value of each of the sites if they were to be used for residential purposes, and that the human interventions would require a range of demolition, repairing, possible removal of contamination, and other alterations, before it could be used for residential development. The Commissioner also retained a valuer, who formed the opinion that much of what existed on the sites could have 'put to use' if the site was reopened as a facility (rather than redeveloped for residential purposes). The evaluator concluded that, at the date of supply, each site was improved and therefore the supplies were not GST-free under section 38-445 of the GST Act. His reasoning was as follows:⁶

First, none (or almost none) of the physical alterations and additions which had altered the land from its natural state to its improved state had become so run down as to be useless and beyond repair at a reasonable cost. In particular, the buildings and other structures which would not be of any use if the land were to be used for a residential development, could still be used for a facility once they were repaired. Second, even if physical alterations and additions such as buildings, trees, paths, parking areas, drainage and services etc, were no longer useful for any purpose, the land retained its character of improved land because it remained cleared and levelled.

- 4.4 The valuation contains an extensive discussion of the meaning of 'improvements' and compares a number of High Court and other cases on this point.
- 4.5 With respect to the requirement that a human intervention must enhance the value of the land ('valuation' approach) the Evaluation provides, if a human intervention 'increases the market value of the land then it will be an "improvement" in the ordinary meaning of the word'⁷ and later in the Evaluation, whether a human intervention increases the value of the land 'is not to be measured by reference to the purpose to which the land can be put', all that is required is an increase from the 'value of the land in its natural state.'⁸
- 4.6 However, the most important principle to emerge from the Evaluation is the 'usefulness' approach to determining whether a human intervention is an improvement. The Evaluation provides that 'an

⁶ R Finkelstein QC, Neutral Evaluation, 15 April 2015 para 87.

⁷ Ibid 69.

⁸ Ibid 76.

increase in the market value of the land is not a necessary requirement for a human intervention to be characterised as an "improvement"...it will be sufficient if the activity improves the *usefulness* of the land for the occupant.⁹ The Evaluator reached this conclusion after considering *Goldsworthy Mining Ltd v Federal Commissioner of Taxation* (1975) 132 CLR 463, *Dampier Mining Co Ltd v Federal Commissioner of Taxation* (1981) 147 CLR 408 and *Brisbane City Council v Valuer-General for State of Queensland* (1978) 21 ALR 607. These cases broadly considered whether dredging work undertaken on the sea-bed, which had the effect of making the land more useful (by allowing carriers to navigate the waterway), was an improvement for the purpose of claiming a deduction for the cost of the works..

- 4.7 The Evaluation also considers that improved land can revert back to being unimproved land and notes that both the taxpayer and the Commissioner accept that this will occur if the improvements have been 'exhausted'. The Evaluation provides the following example (which notably considers both the 'valuation' and 'usefulness' approach as to when a human intervention is exhausted):¹⁰

Fencing land in its natural state to enable that land to be used for grazing will constitute an improvement. It will also likely increase the value of the land by the cost of the fencing, perhaps with some allowance for depreciation. Assume that the fencing is not maintained for many years with the consequence it no longer serves its fencing function and it is not economic to repair. It might then correctly be said that the land is no longer improved when compared with its natural state.

- 4.8 The Evaluation provides that land that is levelled and cleared ceases to be unimproved land 'probably forever'.¹¹ That is, the human intervention of levelling and clearing may never be exhausted.

ATO Position

- 4.9 The ATO has indicated agreement with the principles expressed in the first ADR, including the new 'usefulness' approach.
- 4.10 The ATO has also stated that further evaluations should be evaluated by the same evaluator based on the principles in the first ADR. The State Treasury departments have subsequently agreed in early 2016 with the ATO that further disputes may be resolved based on the principles in the first ADR but by *different* evaluators.

Issues with first ADR / ADR process

- 4.11 There are a number of issues that arise from the overall ADR process, and the principles adopted in the first ADR in particular:
- **Is it appropriate for government entities to be bound by the single opinion of the evaluator in the first ADR matter?** The ATO had itself initially stated that it would not be appropriate for the ATO to be bound by a single opinion. It now appears that the ATO is seeking to depart from its agreement to progress a number of lead cases and is seeking instead to apply the principles in the first ADR to completely different facts and circumstances.
 - **How can government entities apply the principles in the Evaluation?** The ATO has made limited public disclosure of the facts of the Evaluation; government entities were not able to see how the matter was run and have not been made privy to the specific facts of the dispute. Unimproved land matters turn on the specific factual matters of each dispute. A human intervention (e.g. a building) may or may not be an improvement depending on either the particular circumstances of the human intervention or the particular circumstances of the land (if for example, the human intervention has contributed to land degradation). Furthermore, although the Evaluation provides a comprehensive discussion of what is an 'improvement', what would be more useful for government entities, in determining their eligibility to apply the GST unimproved land concessions, would be examples of human interventions that are *not* improvements. Furthermore, GSTR 2006/6 has not yet been updated to articulate the new principles and how they should be applied.

⁹ Ibid 69.

¹⁰ Ibid 79.

¹¹ Ibid 80.

- **Do the principles in the Evaluation apply to Item 4 of the margin scheme?** The scope of the Evaluation was limited to matters involving the application of section 38-445 of the GST Act, rather than Item 4 of the margin scheme. The majority of disputes involving unimproved land are in respect of the eligibility to apply Item 4 of the margin scheme. It is possible that the concept of 'improvements' may have a different meaning in the context of Item 4.
- **What about other issues not covered in the first ADR?** The facts of the dispute in the Evaluation were narrow and not representative of the broader disputes arising in this area. The first ADR matter did not consider whether a single title can be partly GST-free under section 38-445, how to determine if subdivided land is unimproved where the land contains only part of a human intervention, and how to determine when various forms/levels of re-growth of once cleared land represent an exhaustion of the original clearing. The last issue of clearing is a particularly common one, given the evidentiary burden of proving the natural state of land.

Issues with the 'Usefulness' Approach

- 4.12 Expanding the meaning of 'improvement' to include human interventions that improve the usefulness of land when compared with its natural state, but not the value of the land, could result in a legislative outcome that was never intended by Parliament. For example, by operation of Item 4 and sub-section 75-10(3A) of the GST Act, where a government entity holds unimproved land at 1 July 2000 that is subsequently improved before supply, GST is intended to be charged on the difference between the sale price and the value of the unimproved land at the date of sale. Essentially, the intended effect is that the value of the unimproved land is not subject to GST and that only the value of the improvements will be taxed.¹² There is an assumption in these provisions that an improvement enhances the value of the land (cf. increase the usefulness without enhancing the value).
- 4.13 The Evaluation provides that '[i]t will be a rare case where an improvement in the usefulness of land will not also result in an increase in its value.' However, due to the large land holdings of government entities and equally, the vast array of activities conducted by government entities, this principle has already proved to be an issue for some government entities.
- 4.14 For example, consider a large vacant block that is located next to a major highway. During the construction of the highway, concrete hardstands are set on that vacant lot. A hardstand is a paved area for parking heavy vehicles; they have limited application outside this use. The hardstands do not enhance the value of the land as they will have to be removed by virtually any subsequent purchaser of the land. They cannot be used as building foundations as they were not designed for this purpose. In all likelihood, the hardstands probably decrease the value of the land as they will need to be removed prior to any subsequent use of the land and the purchaser will incur an associated removal cost. However, they do improve the usefulness of the land as now heavy vehicles can park on the land in the event that the adjacent road ever has to be maintained or rebuilt. On this basis, is the land now improved? Other examples of human interventions that may increase the usefulness of the land without enhancing the value of the land include high-voltage overhead powerlines and internal fencing. Based on the principles in the Evaluation these would now likely be considered an improvement.

5. What Next?

- 5.1 By adopting the principles in the first ADR and seeking to apply them broadly, the ATO risks creating a set of pseudo-precedents that will, over time, become the 'accepted law' on what constitutes unimproved land for the purposes of these GST concessions. While this would bring some certainty to tax payers, it can also bring some risk for both the ATO and taxpayers.
- 5.2 For example, the meaning of 'improvements' may ultimately be considered by the Courts – either as it arises under other legislation, or if there is a contractual dispute between private parties that requires the Court to determine whether land is unimproved. If the interpretation of the Courts is different to the pseudo-precedent created by the ADR process, the ATO may be placed in an extremely difficult position.
- 5.3 In the meantime, we eagerly await the second (and third, and fourth...) ADR decision.

¹² Supplementary Explanatory Memorandum to the *Indirect Tax and Consequential Amendments Bill (No 2) 1999* (Cth) 1.52

