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RECENT DEVELOPMENTS IN STATE TAXES: TIPS AND TRAPS TO BE MINDFUL OF

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RECENT DEVELOPMENTS IN STATE TAXES: TIPS AND TRAPS TO BE MINDFUL OF

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1. INTRODUCTION

There have been quite a number of recent developments in Victorian State Taxes including significant litigation as well as legislative reform. This paper will highlight several key areas where important changes have occurred and where getting it wrong can be costly.

2. TRANSFER OF PARTNERSHIP INTERESTS - IMPLICATIONS OF DANVEST

The recent Supreme Court decision in *Danvest Pty Ltd v Commissioner of State Revenue*¹ highlights the Commissioners desire to aggressively pursue changes in partnership interests where valuable landholdings are concerned. The Commissioner lost the case at first instance but has filed an appeal which will be heard by the Court of Appeal later this year.

The primary issue in the case was whether the sale of partnership interests from two partners to the appellants (Danvest Pty Ltd (**Danvest**) and Bullhusq Pty Ltd (**Bullhusq**)) constituted a transfer of dutiable property within the meaning of section 7(1)(a) of the Duties Act.

The facts are fairly straight forward. In 2002, a partnership was established by Deed of Unit Partnership with three partners being Northpeak Pty Ltd (**Northpeak**) (40%), Lopet Pty Ltd (**Lopet**) (40%) and Danvest (20%). A manager, Fair Course Pty Ltd (subsequently renamed Gold Age Australia Pty Ltd) (**Manager**) was also appointed to hold three properties on trust for the partnership. The properties were leased to another entity called Gold Age Pty Ltd (**Gold Age Lessee**) as trustee for the Gold Age Trust which conducted an aged care business on the properties. Subsequently in 2004, Gold Age Lessee was replaced as trustee of the Gold Age Trust with Danvest being appointed in its place.

¹ [2017] VSC 125.

In 2013, an agreement was reached for the sale of the business including the units in the partnership among other things. Under the sale agreement, Northpeak and Lopet sold their partnership interests (totaling 80%) to Danvest and Bullhusq. Danvest and Bullhusq also acquired the aged care 'business' conducted by the Gold Age Trust. Importantly, the properties owned by the Manager continued to be so held on behalf of the partnership.

The Commissioner issued a private ruling to Danvest and Bullhusq expressing the view that they had acquired an 80% interest in the property of the partnership: s 10(1)(ac) comprising a beneficial interest in the assets of the partnership some of which were estates in fee simple: s 10(1)(a)(i) and some of which were goods the subject of an arrangement that includes a dutiable transaction over an estate or interest in land: s 10(1)(d). The Commissioner argued in the alternative that there had been a change in beneficial ownership in the underlying assets of the partnership under s 7(1)(b)(vi) or that there had been relevant acquisition under Chapter 3 of the Duties Act. As a result, the Commissioner issued an assessment for \$1,765 million.

The key issue for the Court was the nature of a partner's interest in partnership property. More specifically, the question was whether such interests are interests 'in' an estate in fee simple within the meaning of s 10(1)(ac) of the Duties Act and therefore dutiable property.

The term 'interest' is defined in the s 3(1) of the Duties Act as including an estate or proprietary right. The Commissioner contended that this definition of 'interest' and the language of s 10(1)(ac) are broad and therefore that 'interest' should not be qualified or limited in any way.

The Court (Croft J) held however, that 'what was acquired [by Danvest and Bullhusq] was no more than an equitable chose in action – the right to partnership property, as a mere expectancy, on the dissolution of the partnership and realisation of assets.'² Further, the interest must be 'in' the estate in fee simple. Accordingly, the Court accepted 'that interest must necessarily be of a proprietary nature in the land owned by the

² Above n 22, para 39.

Manager.’³ Significantly, ‘the interest must be in land, and not merely related to land. It must be a proprietary interest in that land.’⁴

The Commissioner also submitted that ‘interest’ for the purposes of s 10(1)(ac) may be a present, future or potential interest. This submission was also not accepted as the Court concluded that the definition of interest in section 3 does not use this language – if Parliament had intended the defined term ‘interest’ to extend to a future or contingent interest it would have said so.⁵

After considering several further cases⁶, Justice Croft found that ‘the interest held by a partner is a chose in action entitling the partner to a proportion of the surplus after the realisation of assets and the payment of debts and liabilities. It is a species of personal property and confers no equitable proprietary interest in the partnership assets.’⁷

The Court then indicated that this is a case similar to *Livingstone*⁸ and *CPT Custodian*⁹ where a trustee owns both legal and beneficial ownership for others. All that is conferred on those others (being the partners in this case) are *equitable rights* against each other and against the trustee. Although the rights may permit partnership assets (such as land) to be exploited, no estate or interest in those assets, including the land was thereby carved out.¹⁰

³ Above n 22, para 40.

⁴ Above n 22, para 43.

⁵ Above n 22, para 45.

⁶ Cf *Commissioner of Stamp Duties (Queensland) v Livingstone* (1964) 112 CLR 12; *CPT Custodian Pty Ltd v Commissioner of State Revenue* (2005) 224 CLR 98; *Commissioner of State Taxation (SA) v Cyril Henschke Pty Ltd* (2010) 242 CLR 508; *Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Ltd* (1974) 131 CLR 321; *United Builders Pty Ltd v Mutual Acceptance Ltd* (1980) 144 CLR 673.

⁷ Above n 22, para 61.

⁸ *Commissioner of Stamp Duties (Queensland) v Livingstone* (1964) 112 CLR 12.

⁹ *CPT Custodian Pty Ltd v Commissioner of State Revenue* (2005) 224 CLR 98.

¹⁰ Above n 22, para 96 referring to *Sojitz Cod Resources Pty Ltd v Commissioner of State Revenue* [2016] 1 Qd R 75.

As indicated above, the case is subject to appeal to the Court of Appeal. In the meantime, the Commissioner has advised taxpayers to voluntarily disclose any arrangements or transactions similar to those in this case. Given that Victoria does not have specific provisions dealing with changes in partnership interests (as is the case in other jurisdictions)¹¹, it is likely that the Commissioner will seek legislative reform in this area should it be unsuccessful in any appeals in Danvest.

3. FOREIGN PURCHASERS, ABSENTEE OWNERS AND VACANT PROPERTY

Over the past five years there has been a significant increase in the level of foreign investment in Australian residential property rising from \$17.2 billion in proposals being approved in 2012-13 to \$72.4 billion in 2015-16.¹² With this increased demand for Australian real estate by foreign investors, various States have introduced measures to moderate investment in residential property by foreign purchasers. Measures have also been introduced to discourage leaving residential properties unoccupied for extended periods. The measures introduced include an additional duty imposed on foreign purchasers and land tax surcharges imposed on vacant residential properties in Victoria. Similar provisions also operate in other States and Territories.

2.1 Duty surcharge for foreign investors

The foreign purchaser additional duty (**FPAD**) provisions were first introduced in Victoria on 1 July 2015 imposing additional duty of 3%. The provisions were subsequently amended with effect from 1 July 2016 to impose additional duty of 7%. FPAD essentially imposes additional duty on direct and indirect acquisitions of residential property in Victoria¹³ by

¹¹ Cf *Duties Act* 1997 (NSW) s 9A and *Duties Act* 2001 (Qld) Part 7.

¹² See Foreign Investment Review Board, Annual Report 2015-16, Table 3.4 on page 22.

¹³ I note that although other jurisdictions also impose FPAD, this paper will only focus primarily on the Victorian provisions.

foreign purchasers. The provisions apply to acquisitions under both Chapter 2 and Chapter 3 of the *Duties Act* 2000 (**Duties Act**) and include dutiable leases.

2.1.1 Who is a 'foreign purchaser'?

Section 3(1) of the Duties Act defines 'foreign purchaser' to mean:

- a) *A foreign natural person;*
- b) *A foreign corporation; or*
- c) *The trustee of a foreign trust.*

A 'foreign natural person' is in turn defined as meaning a person who is not any of the following:

- a) *An Australian citizen¹⁴;*
- b) *The holder of a permanent visa¹⁵;*
- c) *A New Zealand citizen who is the holder of a special category visa.¹⁶*

A 'foreign corporation' is in turn defined as meaning:

- a) *A corporation that is incorporated outside Australia; or*
- b) *A corporation in which one of the following persons has a controlling interest –*
 - i) *A foreign natural person;*
 - ii) *Another foreign corporation;*
 - iii) *The trustee of a foreign trust.*

In general, a person will be regarded as having a controlling interest in a foreign corporation if they hold more than 50% of the shares in the corporation or are in a position to control more than 50% of the voting power or potential voting power of the corporation.¹⁷ That is, more than 50% control is required to establish a controlling interest in Victoria.

¹⁴ within the meaning of the *Australian Citizenship Act* 2007 of the Commonwealth.

¹⁵ within the meaning of section 30(1) of the *Migration Act* 1958 of the Commonwealth.

¹⁶ within the meaning of section 32(1) of the *Migration Act* 1958 of the Commonwealth.

¹⁷ *Duties Act* 2000, s 3A.

Relevantly, in determining whether a person is in a position to control voting or potential voting power, the Commissioner may have regard to direct and indirect control exercisable under arrangements or practices whether or not having legal or equitable force or basis.¹⁸ This means that it is likely the Commissioner will have regard to all rights and powers a person may have regarding such matters as veto and rights exercisable now or in the future which might have a bearing on voting power.

A 'foreign trust' is defined as meaning a trust in which one of the following persons has a substantial interest in the trust estate:

- a) *A foreign corporation;*
- b) *A foreign natural person;*
- c) *Another person that holds the substantial interest as trustee of another foreign trust.*

For the purposes of this definition, a person will have a 'substantial interest' in a trust estate if they have a beneficial interest of more than 50% of the capital of the estate of the trust.¹⁹ Relevantly, where in the case of a discretionary trust, the trustee has a discretion as to the distribution of capital of the trust to a person, that person is taken to have a beneficial interest in the percentage the trustee is empowered to distribute to him or her.²⁰ As a result, this may often lead to a harsh outcome where land is owned by an Australian resident trust in which at least one beneficiary of that trust is a foreign corporation or foreign natural person.

Another point to note is that in determining whether the 50% threshold has been met, the Commissioner may also aggregate interests held by associated persons.²¹ The Commissioner cannot however aggregate interests held by two foreign persons unless those persons are associated.

Finally, in Victoria, the Commissioner also has the power to deem a person to hold a controlling interest in a corporation or a substantial interest in a trust if that person has the ability to practically influence the

¹⁸ *Duties Act 2000*, s 3A(3) and (4).

¹⁹ *Duties Act 2000*, s 3B(1).

²⁰ *Duties Act 2000*, s 3B(2).

²¹ *Duties Act 2000*, ss 3A(2) and 3B(3).

financial and operating policies of the corporation or trust.²² This is however subject to section 3E of the Duties Act which provides that a person will not be deemed to hold such an interest if the Treasurer exempts the person.

2.1.2 What 'property' is subject to FPAD?

The FPAD provisions apply only to the direct or indirect acquisition of 'residential property'. Residential property is defined in section 3G of the Duties Act as broadly referring to land capable of being used solely or primarily for residential purposes that may lawfully be used in that way, land which includes a building that the person intends to refurbish for residential purposes and land on which a person intends to construct a building or undertake development for residential purposes.

Importantly, 'residential property' does not include land capable of being used or intended to be used as commercial residential premises, a residential care facility, a supported residential service or a retirement village.²³

Issues may arise however on applying the definition of 'commercial residential premises' which takes its definition from the GST legislation.²⁴ This definition²⁵ includes a hotel, motel, inn, hostel, boarding house and premises used to provide accommodation in connection with a school (except premises to the extent that they are used to provide accommodation to students in connection with an educational institution that is not a school). This raises the question as to the treatment of these sorts of premises – are they 'designed and constructed solely or primarily for residential purposes' or not?

2.1.3 Change of use of the property

In Victoria, FPAD will also arise in relation to non-residential property acquired by a foreign purchaser after 1 July 2015 if that purchaser subsequently forms an intention to develop or convert it into residential

²² *Duties Act 2000*, ss 3C and 3D.

²³ *Duties Act 2000*, s 3G(2).

²⁴ *Duties Act 2000*, s 3G(3).

²⁵ *A New Tax System (Goods and Services Tax) 1999* (Cth), s 195-1.

premises.²⁶ Of concern is the fact that there is no apparent time limit on how long the change of intention test continues to operate which could effectively result in an additional 7% duty liability arising many years after the initial purchase.

2.2 Land tax surcharge for absentee owners

All property in Victoria is subject to land tax, unless an exemption applies or the property's site value is below the threshold (\$250,000).²⁷ Land tax is assessed annually on the taxable (site) value of all property of an owner as at midnight on 31 December in the preceding year. However, in addition to the general rate of land tax, trustees of trusts generally pay a surcharge and absentee owners are now also liable to a surcharge.

The absentee owner surcharge was introduced into the Victorian *Land Tax Act 2005 (LTA)* on 1 January 2016 and currently imposes an additional surcharge of 1.5% on all non-exempt land owned by an absentee owner.²⁸

2.2.1 Who is an 'absentee owner'?

Section 3(1) of the LTA defines an absentee owner as an absentee person who is an owner of land. Absentee person in turn is defined as either:

- a) *A natural person absentee;*
- b) *An absentee corporation; or*
- c) *A trustee of an absentee trust.*

A 'natural person absentee' is defined as meaning a natural person who is not an Australian citizen or resident and –

- a) *Who does not ordinarily reside in Australia; and*
- b) *Who –*
 - i) *was absent from Australia on 31 December in the year immediately preceding the tax year; or*

²⁶ *Duties Act 2000*, s 18A.

²⁷ *Land Tax Act 2005*, Sch 1, Part 1, Table 1.4.

²⁸ see *Land Tax Act 2005*, Sch 1, Part 4, Table 4.2 and in the case of absentee trusts, Sch 1, Part 5, Table 5.2.

ii) in the year immediately preceding the tax year, was absent from Australia for a period of at least 6 months or for periods that when added together equal a period of at least 6 months.

Further, an 'absentee corporation' is defined in section 3(1) of the LTA as meaning a corporation that is incorporated outside Australia or in which an absentee person has an absentee controlling interest. According to section 3A of the LTA, an absentee person will have an 'absentee controlling interest' in a corporation if:

- a) they alone or acting together with another absentee person, can control the composition of the board of the corporation; or*
- b) they alone or acting together with another absentee person, are able to cast or control the casting of more than 50% of the maximum number of votes that might be cast at a general meeting of the corporation; or*
- c) they alone or acting together with another absentee person, hold more than 50% of the issued shares in the corporation.*

In determining whether a person has such an interest, the Commissioner will also consider the entitlements attaching to shares issued to the person including any rights or powers attached to those shares that either expand or limit the right to participate in a distribution of profits or capital.²⁹ Notwithstanding the above, a person will be taken not to hold such a controlling interest if they hold an exemption issued by the Treasurer.³⁰ According to the State Revenue Office website, 'the exemption is intended to apply to those corporations which conduct a legitimate commercial operation in Australia and whose commercial activities make a strong and positive contribution to the Victorian economy and community by engaging local labour and using local materials and services through an Australian based entity.'³¹ The Treasurer has also issued guidelines outlining the basis on which

²⁹ *Land Tax Act 2005*, s 3A(2).

³⁰ *Land Tax Act 2005*, s 3B(1).

³¹ State Revenue Office website, <http://www.sro.vic.gov.au/absentee-owner-surcharge> retrieved on 23 October 2017.

exemption decisions are to be made and these can be found and should be referred to prior to lodging any exemption application.³²

An absentee person also includes the trustee of an absentee trust which is defined in section 3(1) of the LTA as a trust under which at least one absentee beneficiary—

- a) has a beneficial interest in land subject to a fixed trust; or*
- b) is a unitholder in a unit trust scheme; or*
- c) is a specified beneficiary of a discretionary trust.*

Significantly, the definition of absentee trust is much narrower than the definition of foreign trust in the Duties Act discussed above. Whereas the definition of beneficiary under a foreign trust potentially captures all beneficiaries under a discretionary trust, the equivalent definition (of absentee trust) in the LTA is limited to specified beneficiaries only. This is necessary as it is possible that nearly all trusts have at least one foreign general beneficiary which would result in most if not all discretionary trusts being subjected to the absentee owner surcharge rate of land tax whilst there existed a foreign general beneficiary.

2.3 Vacant Residential Land Tax

The Vacant Residential Property Tax (**VRLT**) will apply in Victoria from 1 January 2018. The measure has been introduced to help address the lack of housing supply in Victoria and discourage owners from leaving homes unoccupied for extended periods. The VRLT will apply to homes in various municipal council areas in inner and middle Melbourne where those homes were unoccupied for more than six months in the preceding calendar year. This tax will impose an additional tax of 1% of the capital improved value of vacant residential land held by all property owners irrespective of whether they are an Australian or foreign owner.

Further, and something to be mindful of, the State Revenue Office has advised that as details of this new tax were only released in May 2017, homes will be treated as having been occupied from 1 January to 30 April

³²<http://www.gazette.vic.gov.au/gazette/Gazettes2015/GG2015G033.pdf#page=28> from gazette page 1802.

2017 (a period of 4 months) thus requiring properties to be occupied for a further two months between 1 May and 31 December 2017 in order to meet the six-month occupancy test.

4. BEWARE DUTIABLE LEASES

Although there have been no recent changes to the lease provisions in Victoria, the Commissioner has in recent times considered these arrangements more closely and taken a more aggressive approach to imposing duty on leases where valuable fixtures are involved.

Under section 7(1)(b)(v) and (va) of the Duties Act, the granting or assignment of a lease may give rise to a liability to duty on the value of the land the subject of the lease.

The Commissioner has stated that the intention of these provisions is to capture those leasing arrangements whereby a lease is used to effectively transfer valuable rights in the underlying land and/or the economic benefits of the land. This is because, under these arrangements, the lessee acquires rights and benefits effectively equivalent to those obtained when a person acquires the land directly.

Section 7(1)(b)(v) of the Duties Act provides that duty is charged on:

- v) the granting of a lease for which any consideration other than **rent reserved** is paid or agreed to be paid, either in respect of the lease or in respect of—*
 - (A) a right to purchase the land or a right to a transfer of the land;*
 - (B) an option to purchase the land or an option for the transfer of the land;*
 - (C) a right of first refusal in respect of the sale or transfer of the land;*
 - (D) any other lease, license, contract, scheme or arrangement by which the lessee, or an associated person of the lessee,*

obtains any right or interest in the land that is the subject of the lease other than the leasehold estate.

Section 7(1)(b)(va) of the Duties Act provides that duty is charged on:

- va) the transfer or assignment of a lease for which any consideration is paid or agreed to be paid, either in respect of the transfer or assignment or in respect of—*
- (A) a right to purchase the land or a right to a transfer of the land;*
 - (B) an option to purchase the land or an option for the transfer of the land;*
 - (C) a right of first refusal in respect of the sale or transfer of the land;*
 - (D) any other lease, license, contract, scheme or arrangement by which the lessee, or an associated person of the lessee, obtains any right or interest in the land that is the subject of the lease other than the leasehold estate.*

'Rent reserved' in relation to a lease is defined in section 3(1) of the Duties Act as meaning the rent paid or payable during the term of the lease and amounts paid or payable for the right to use the land under the lease. Examples of rent reserved are set out in the Act under this definition and include rates, charges, taxes, maintenance, utilities, legal costs required to be paid by the lessee on behalf of the lessor in relation to the grant of the lease, insurance premiums, marketing costs and car park contributions.

The Commissioner looks at leases lodged for assessment very closely in terms of forming a view as to whether the lease is a dutiable lease. As he explains in Revenue Ruling DA.053, the factors he will consider include:

- a) the nature and circumstances of the transaction as a whole, including the rights, obligations and responsibilities of the parties to the transaction (whether contained in one or more agreements);*
- b) the value of the covenant (in terms of its benefit to the lessor and/or cost to the lessee, including associated persons of the lessor and lessee) relative to the value of the underlying land;*

- c) whether the covenant imposes a positive obligation on the lessee to make improvements to the land which is the subject of the lease or is merely a permissive right subject to the consent of the landlord;*
- d) where a covenant requires the lessee to make improvements, the nature of the improvements and whether they will yield a long term enduring benefit to the lessor or are merely made to allow the lessee to fully use and enjoy the land for the permitted purpose during the lessee's tenancy;*
- e) the rent payable under the lease and whether it is at a market rate; and*
- f) the term of the lease.*

Having regard to the Commissioner's guidance above, there are several key areas to be mindful of when negotiating and drafting leases. The Commissioner often regards very long term leases with minimal rent as prima facie liable to duty. Similarly, where a premium has been paid for the granting of the lease, the lease is likely to be dutiable particularly where that premium appears to reflect the market value of the land the subject of the lease.

It is less clear however, where the lessee is required to undertake improvements on the land prior to the lease being granted. The Commissioner will often look to the value or cost of these improvements and whether the lessee was obligated to make the improvements or merely permitted to do so. This is a fine line as the Commissioner will often conclude that there was an obligation to make the improvements if not making them would have rendered the entire lease arrangement ineffective or otherwise of little value to the parties.

The Commissioner will also have regard to related transactions involving sale of associated assets as he is often mindful to aggregate transactions that artificially separate transfers of fixed assets and associated leases. In this respect, it is important to consider the existence and value of any fixtures on the relevant leased land. Section 22A states that the value of any tenant's fixtures on land are to be included in the value of that land. However, they are not to be included if they are not being sold or transferred to the purchaser. Arguably, in the case of a lease transfer, the tenant's fixtures (being property of the current lessee) are likely to be

also transferred to the transferee of the lease. But there are arguments that can be made both ways.

The correct treatment of leases and fixtures also often arises in the Landholder Acquisition provisions in Chapter 3 of the Duties Act. In Revenue Ruling DA.055, the Commissioner has indicated that if a person makes a relevant acquisition in a landholder whose Victorian landholdings comprise:

- a) only leasehold estates that are not dutiable property, no duty will be payable as the acquisition of the interest is exempt under section 89D(a) of the Duties Act;*
- b) leasehold estates (none of which are dutiable property) and freehold land, duty will be payable with reference to the value of the freehold land only as the concession in section 89E of the Duties Act will apply to exclude the non-dutiable leasehold estates from the duty calculation; and*
- c) leasehold estates (some or all of which are dutiable property) and/or freehold land, duty will be payable with reference to the value of all the landholder's landholdings that would be dutiable on a transfer under Chapter 2 of the Duties Act (both leasehold and freehold estates).*

The Commissioner generally takes the above approach to the imposition of duty on leases indirectly acquired or transferred under the landholder provisions in Chapter 3. However, again, where valuable fixtures are involved, he is likely to form the view that those leases are dutiable leases which include the value of the fixtures thereon. Depending on the nature of the transaction involved, there are arguments that can be made to exclude the value of these fixtures in reliance of section 154A of the *Property Law Act 1958*.

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