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# AUSTRALIAN TAX ALERT

## THE MEANING OF "CREDITABLE PURPOSE" IN THE AUSTRALIAN GST ACT

Justice Davies recently handed down her decision in the case of *Rio Tinto Services Ltd v FCT* [2015] FCA 94, reported at 2015 WTB 7 [174]. This important test case considers the meaning of the expression "creditable purpose" in the GST Act. "Creditable purpose" is a fundamental concept relevant to the claiming of input tax credits.

The case relates to residential accommodation supplied in remote mining townships. It will be relevant for any businesses that may provide remote area housing.

However, as discussed further below, the decision will have important implications in other circumstances where taxpayers consider their acquisitions have been made for a creditable purpose, thereby giving rise to an input tax credit entitlement.

### BACKGROUND

Based on the published decision, the background facts are as follows:

- Rio Tinto Services Ltd ("**Rio Tinto**") is the Representative Member of a GST group that includes Hamersley Iron Pty Ltd

("Hamersley") and Pilbara Iron Company (Services) Pty Ltd ("**PICS**"). As the Representative Member, it is Rio Tinto that is entitled to input tax credits for any creditable acquisitions made by Hamersley and PICS.

- Hamersley is in the business of mining and selling iron ore. The mines are operated in remote areas of the Pilbara region of Western Australia.
- Hamersley owns approximately 2,300 houses and apartments which are used to provide accommodation to employees and contractors in mining townships. The premises may also be leased to people working in services industries that support the mining townships. Hamersley leases the residential premises for a loss, thereby subsidising the accommodation. This subsidisation assists in attracting and retaining people to work in the Pilbara region.
- For the year ended 31 December 2010, 99.88% of Rio Tinto's revenue related to iron ore mining and sales. Only 0.12% of revenue related to its residential leasing activities.

- During the October 2010 tax period, Hamersley and PICS incurred costs relating to:
  - construction and purchase of new housing;
  - refurbishment, minor works, maintenance and repairs of the residential premises;
  - mould removal, remediation and general hygiene cleansing; and
  - cleaning housing, landscaping grounds and pool maintenance.
- The GST referable to the above costs for the October 2010 tax period was \$573,515.74.
- Rio Tinto was seeking a declaration that it was entitled to either:
  - a full input tax credit for the GST amount of \$573,515.74; or
  - an input tax credit for 99.88% of the GST amount.

### RELEVANT LEGISLATIVE SCHEME

The following summarises the key relevant legislative provisions in the GST Act:

- An entity is entitled to an input tax credit for any "creditable acquisition" the entity makes – s 11-20.
- To qualify as a "creditable acquisition", an acquisition must be made solely or partly for a "creditable purpose" – s 11-5(1).
- An entity will make an acquisition for a creditable purpose to the extent it makes the acquisition in carrying on the entity's "enterprise" – s 11-15(1).
- However, an entity will not make an acquisition for a creditable purpose "to the extent the acquisition relates to making supplies that would be input taxed" – s 11-15(2)(a).
- Residential leasing supplies are input taxed – s 40-35(1).

In para 11 of the decision, it is stated that the Commissioner accepts the acquisitions "fall within the terms of s 11-15(1)" and were acquired in the course of the enterprise conducted by Hamersley. Therefore, the issue in dispute was whether:

- s 11-15(2)(a) applies to block the input tax credit that would be otherwise be available; and
- if s 11-15(2)(a) does apply, the extent of that application.

### RIO TINTO'S CASE

Rio Tinto submitted that its residential accommodation supplies (which are input taxed) were not a commercial end objective. Rather, it was submitted that the accommodation is incidental to Hamersley's mining operations (and a necessary and important part of those operations).

Accordingly, Rio Tinto's case was that the relevant acquisitions were either made:

- wholly for a creditable purpose, on the basis that the acquisitions related wholly to the mining operations (meaning a full credit is available); or
- 99.88% for a creditable purpose, on the basis that the acquisitions relate 99.88% to mining operations and only 0.12% to residential leasing supplies (meaning a credit is available for 99.88% of the GST amount).

### THE COMMISSIONER'S CASE

The Commissioner's submissions were stated succinctly in para 18 of the decision as follows:

*"... s 11-15(2)(a) applies because the acquisitions in question had a direct and immediate connection with the supply of residential accommodation by way of lease, being an input taxed supply".*

### WHAT IS THE LEGISLATIVE POLICY FOR ALLOWING INPUT TAX CREDITS?

In *HP Mercantile Pty Ltd v FCT* [2005] 143 FCR 533, Hill J (at para 13) summarised the legislative policy for allowing input tax credits in the following terms:

*"The genius of a system of value added taxation, of which the GST is an example, is that while tax is generally payable at each stage of commercial dealings (supplies) with goods, services or other things, there is allowed to an entity which acquires those goods, services or other things as a result of a taxable supply made to it, a credit for the tax borne*

by that entity by reference to the output tax payable as a result of the taxable supply. That credit, known as an input tax credit, will be available, generally speaking, so long as the acquirer and the supply to it (assuming it was a "taxable supply") satisfied certain conditions, the most important of which, for present purposes, is that the acquirer make the acquisition in the course or carrying on an enterprise and thus, not as a consumer. The system of input tax credits thus **ensures that while GST is a multi-stage tax, there will ordinarily be no cascading of tax.** It ensures also that the tax will be payable, by each supplier in a chain, **only upon the value added by that supplier**". [Emphasis added]

Rio Tinto sought to rely on this and other related policy statements to support its argument that input tax credits should be available for the relevant acquisitions.

## JUDGEMENT OUTCOME

Justice Davies agreed with the Commissioner's view that the relevant acquisitions had a "direct and immediate" connection with the input taxed supply of residential accommodation. Her Honour held that this connection "constitutes a sufficient and material" relationship for the purposes of s 11-15(2)(a). Consequently, her Honour found for the Commissioner and rejected Rio Tinto's interpretation of the provisions. This means that Rio Tinto is not entitled to any input tax credits for the relevant acquisitions.

In reaching this decision, Davies J made the following 3 points (at paras 30 through 32):

- The task of statutory construction does not seek to identify or assume the underlying policy of a provision and then construe that policy. Her Honour considered that Rio Tinto was seeking to do this.
- The fact that the residential accommodation was subsidised, and hence provided for a loss, does not prevent the application of s 11-15(2)(a).
- It is the transaction that determines the GST outcome.

## WHY WAS RIO TINTO'S APPORTIONMENT ARGUMENT REJECTED?

In the author's view, it is not clear from the decision why Rio Tinto's apportionment arguments were rejected.

At para 33 of the decision, Davies J stated:

*"A finding that the provision of accommodation was an essential and necessary incident of Hamersley carrying on its mining operations would not mean that s11-15(2)(a) was not engaged. It may be accepted that Hamersley's leasing activities are wholly incidental to its mining operations and merely a means to Hamersley carrying on its business **but the relevant inquiry is whether the acquisitions in question were connected with the input taxed supplies that Hamersley makes as part of its activities**".* [Emphasis added].

As outlined above, her Honour found there was a connection between the input taxed supplies and the relevant acquisitions. This connection was sufficient to engage s 11-15(2)(a).

However, even if s 11-15(2)(a) is engaged, it only applies "to the extent that" an acquisition relates to an input taxed supply. Therefore, if it may be "accepted that Hamersley's leasing activities are wholly incidental to its mining operations", it is unclear why an apportionment issue does not arise.

It could perhaps be inferred from the decision that if an acquisition has a "direct and immediate connection" with an input taxed supply, it is unnecessary to consider further whether the acquisition may also relate to other supplies that are not input taxed. However, this is not made expressly clear in the decision.

## WOULD THE RESULT HAVE BEEN DIFFERENT IF THE ACCOMMODATION WAS PROVIDED AT NO COST?

Other commentators have suggested that if the residential accommodation had been supplied for no cost, the decision would have been different.

There are divergent views as to whether a supply that is made for no consideration is "out-of-scope" for GST purposes and therefore incapable of being an input taxed supply.

The argument is that if a supply made for no consideration is out-of-scope and not input taxed, s 11-15(2)(a) cannot be applied to block input tax credits for acquisitions relating to that supply.

This issue was not raised in the *Rio Tinto* case (or at least not in the published decision). While it may be debatable that the outcome should be different if there is no consideration for the accommodation, in the author's view, there is no support for that position in the published decision itself.

### IMPLICATIONS IN OTHER CONTEXTS

As stated at the outset, the decision will have important implications in other contexts.

To illustrate, assume that a company ("**A Ltd**") is in the process of taking over another company ("**B Ltd**"). A Ltd will purchase 100% of the shares in B Ltd. From the date of completion of the purchase, B Ltd will be included as a member of a GST group with A Ltd. Viewed as a single entity, the GST group will only make taxable and GST-free supplies.

As a result of acquiring the shares in B Ltd, A Ltd will be deemed to have made a financial supply that is input taxed. If A Ltd exceeds the financial acquisitions threshold, it will not be entitled to full input tax credits for GST incurred on its takeover costs (such as legal, accounting and corporate advisory fees). Reduced input tax credits may be available for some of the takeover costs.

However, it is interesting to consider whether A Ltd may take the view that, on a "big picture" basis, it incurred the takeover costs with a view to acquiring B Ltd's business operations and hence incurred the takeover costs for a "creditable purpose". In other words, the acquisition of the shares in B Ltd may not have been a "commercial end objective" for A Ltd.

Based on Davies J's decision in the *Rio Tinto* case, such an argument may not be successful. This is because the takeover costs have a direct and immediate connection with the purchase of the shares and "it is the transaction that determines the GST outcome".

The above is but one example and there are many others. These issues could be revisited if the decision is successfully appealed.

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### MORE INFORMATION

For more information, please contact:



**Matthew Cridland**  
Partner  
T +61 2 9286 8202  
matthew.cridland@dlapiper.com

Contact your nearest DLA Piper office:

**BRISBANE**

Level 28, Waterfront Place  
1 Eagle Street  
Brisbane QLD 4000  
T +61 7 3246 4000  
F +61 7 3229 4077  
brisbane@dlapiper.com

**CANBERRA**

Level 3, 55 Wentworth Avenue  
Kingston ACT 2604  
T +61 2 6201 8787  
F +61 2 6230 7848  
canberra@dlapiper.com

**MELBOURNE**

Level 21, 140 William Street  
Melbourne VIC 3000  
T +61 3 9274 5000  
F +61 3 9274 5111  
melbourne@dlapiper.com

**PERTH**

Level 31, Central Park  
152–158 St Georges Terrace  
Perth WA 6000  
T +61 8 6467 6000  
F +61 8 6467 6001  
perth@dlapiper.com

**SYDNEY**

Level 22, No.1 Martin Place  
Sydney NSW 2000  
T +61 2 9286 8000  
F +61 2 9286 4144  
sydney@dlapiper.com

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