GSTR 2005/D1 - Goods and services tax: deposits held as security for the performance of an obligation

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Draft Goods and Services Tax Ruling

Goods and services tax: deposits held as security for the performance of an obligation

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Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners, as it is not a ruling or advice for the purposes of section 37 of the ***Taxation Administration Act 1953****. The final Ruling will be a public ruling for the purposes of section 37 and may be relied upon by any entity to which it applies.*

What this Ruling is about

1. The Ruling explains the Commissioner's views on the operation of Division 99 of *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act) in relation to deposits held as security for the performance of an obligation (security deposits).

2. The Ruling discusses the characteristics of a deposit to which Division 99 applies and explains:

- the meaning of a deposit;
- the difference between a security deposit and a part payment;
- the need for reasonableness in the amount of the security deposit; and
- the meaning of forfeiture of a deposit.

3. The Ruling explains the operation of Division 99 and the special attribution rule for the GST relating to security deposits.

4. Unless otherwise stated, all legislative references in this Ruling are to the GST Act.

Date of effect

5. This draft Ruling represents the preliminary, though considered view of the Australian Taxation Office. This draft may not be relied on by taxpayers or practitioners. When the final Ruling is officially released, it will explain our view of the law as it applies from 1 July 2000.

6. The final Ruling will be a public ruling for the purposes of section 37 of the *Taxation Administration Act 1953* and may be relied upon, after it is issued, by any entity to which it applies. Goods and Services Tax Ruling GSTR 1999/1 explains the GST rulings system and our view of when you can rely on our interpretation of the law in GST public and private rulings.

7. If the final public ruling conflicts with a previous private ruling that you have obtained, the public ruling prevails. However, if you have relied on a private ruling, you are protected in respect of what you have done up to the date of issue of the final public ruling. This means that if you have underpaid an amount of GST, you are not liable for the shortfall prior to the date of effect of the later ruling. Similarly, you are not liable to repay an amount overpaid by the Commissioner as a refund.

Previous Rulings

8. This Draft Ruling replaces Goods and Services Tax Determination GSTD 2000/1. GSTD 2000/1 is withdrawn with effect from the date of issue of this Draft Ruling. You can rely upon GSTD 2000/1 until the date of issue of this Draft Ruling. This means that if you have relied on GSTD 2000/1 to determine the GST treatment of security deposits, then you are protected in respect of that treatment for transactions that happened prior to the release of this Draft Ruling.

Background

9. For GST purposes, a payment is treated as consideration[1] for a supply if it is in connection with, in response to, or for the inducement of the supply. If the payment is consideration for a taxable supply, receipt of the consideration in a particular tax period requires attribution of the GST payable to that tax period.[2]

10. Under the basic rules of the GST Act, the payment of a deposit constitutes part of the consideration for a supply. The GST payable on the taxable supply is subject to the attribution provisions contained in section 29-5.

11. However, when an amount is paid as a security deposit, the special rule set out in Division 99 applies.[3]

[1] Consideration is defined in subsection 9-15(1).
[2] Unless, for entities attributing on a basis other than cash, an invoice has issued in an earlier tax period – see the basic attribution rules contained in section 29-5.
[3] The effect of a special rule is discussed in section 45-5.

12. The Explanatory Memorandum[4] (EM) states:

> If you make a security deposit, the intention is usually that it will be refunded to you when you meet the obligations to which the deposit relates. The deposit may be consideration for a taxable supply. However, it would be pointless for the supplier to charge GST on the deposit if the deposit is to be refunded, in which case the GST would have to be refunded to the supplier.
>
> However, some security deposits later become incorporated in the consideration for a taxable supply. At some point the deposit ceases to be held as a security deposit and is offset against the remaining consideration that is payable. GST should be charged on such deposits if they become part of the consideration for the taxable supply.
>
> Also, if a security deposit made in relation to a taxable supply is forfeited, GST should be payable on the deposit.
>
> For these reasons, ***Division 99*** provides special rules in relation to security deposits.
>
> If a security deposit is made it is treated as not being consideration for a supply (and hence not subject to GST) unless the deposit is forfeited or is applied towards the consideration for the supply. ***Section 99-5***.
>
> If the deposit is forfeited or is applied towards the consideration for the supply, GST is paid on the amount of the deposit. The GST is attributed to the tax period in which the deposit is forfeited or is applied towards the consideration. ***Section 99-10***.

Ruling and explanation

The Purpose of Division 99

13. Subsection 99-5(1) prevents the treatment of a deposit held as a security from being treated as consideration for a supply until such time that the deposit is either forfeited because of a failure to perform the secured obligation, or is applied as all or part of the consideration for a supply.

14. Under subsection 99-10(1), the GST payable on a taxable supply for which the consideration is a security deposit is attributable to the tax period in which the deposit is forfeited or is applied as all or part of the consideration for a supply. The EM[5] contemplates that there are at least two types of security deposit arrangements to which this Division is intended to apply.

[4] Explanatory Memorandum to the A New Tax System (Goods and Services Tax) Bill 1998, paragraphs 6.164 to 6.169.
[5] Paragraphs 6.164 to 6.169.

15. One type of arrangement in which a security deposit is paid involves a contract for the hire of goods, where the supplier holds a security deposit to secure the return of the goods (a hire only contract).

16. The other type of arrangement involves a contract for the purchase of real property, goods or services (a purchase contract), where the purchaser pays a deposit to secure the obligation to complete the purchase.

17. Under either arrangement, the purchaser is usually aware that failure to perform the secured obligation risks forfeiture of the deposit.[6]

'Deposit' to which Division 99 applies

18. To fall within the provisions of Division 99, the consideration received by the supplier must be a 'deposit'.

19. The term 'deposit' is not defined in the GST Act. However, judicial decisions have indicated that the term 'deposit' has a particular meaning in a commercial context. This meaning is discussed in paragraphs 32 to 88 of this Ruling.

Held as security

20. Under Division 99, the deposit must be 'held' as security for the performance of an obligation. However, the GST Act does not explain the concept of a deposit 'held'.

21. We consider that a deposit is 'held' when the person to whom the amount has been paid receives it in the capacity of stakeholder. Normally, in commercial situations, the supplier will be the holder although it makes no difference if a third party holds the deposit as stakeholder.

22. However, an amount paid to a stakeholder ceases to be a security deposit when that amount is applied on behalf of or at the direction of the supplier.

23. The accounting treatment may be evidence of when a deposit has been either forfeited or applied as consideration for a supply. For example, a deposit that is recognised as revenue because it is no longer refundable is indicative of a deposit that is no longer held as security because it has been applied as consideration for a supply.

[6] An ordinary meaning of a 'security' is 'an assurance or guarantee' (*The Macquarie Dictionary*, 2001, rev. 3rd edn, The Macquarie Library Pty Ltd, NSW). The security interest or property is ordinarily 'liable to be forfeited' if the guarantee or undertaking is not fulfilled (*The CCH Macquarie Dictionary of Business*, 1993, CCH Australia Ltd).

Example 1: Deposit held by a stakeholder

24. *Dale enters into a conditional contract to purchase an apartment from Wayne. By mutual agreement with Wayne, Dale pays a deposit to a third party, Tim, to hold on trust awaiting settlement. Tim is not paid any fees or commission from this deposit.*

25. *The deposit is a security deposit for the purposes of Division 99. The deposit is held by Tim as a third party stakeholder until it is applied to Dale's benefit at settlement.*[7]

Performance of an obligation

26. The security deposit secures, for the supplier, the performance of the recipient's obligation under the contract. The nature of the obligation is usually identified and agreed to between the parties upon their entry into the contract and is therefore dependent upon the terms and conditions of each agreement entered into and the conduct of the parties.[8]

27. In a purchase contract, the supplier ordinarily seeks to secure the purchaser's obligation to complete the contract and pay the contracted purchase price.[9]

28. Under a purchase contract, upon the recipient's satisfaction of its obligation secured by the deposit under the contract, the supplier is obliged either to apply the deposit for the purchaser's benefit, usually by applying it towards the total purchase price of the supply, or return it to the purchaser.[10]

29. However, if the recipient fails to perform the obligation, then the security deposit is at risk of forfeiture.

30. Under a hire only contract, the recipient's secured obligation is typically satisfied by returning the hired goods or equipment in a satisfactory condition at the agreed time or date. The hirer either returns the deposit upon the return of the goods or equipment, or keeps the deposit if the goods or equipment are either not returned, or returned damaged.

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[7] GSTR 2000/28 Goods and services tax: attributing GST payable or an input tax credit arising from a sale of land under a standard land contract at paragraphs 28, 37 and 69.

[8] GSTR 2000/28 Goods and services tax: attributing GST payable or an input tax credit arising from a sale of land under a standard land contract at paragraph 64 and Cotton LJ, Bowen LJ, and Fry LJ in *Howe v. Smith* (1884) 27 Ch D 89 at 92, 97, 101.

[9] Coates J in *Reid Motors Ltd v. Wood and Another* (1978) 1 NZLR 319 noted at 325: 'If it was a deposit to be regarded as a security for completion of the purchase it could be retained by the vendor if the purchaser repudiated the contract.'

[10] Fry LJ in *Howe v. Smith* (1884) 27 Ch D 89 stated at 101: 'The practice of giving something to signify the conclusion of the contract, sometimes a sum of money, sometimes a ring or other object, to be repaid or redelivered on the completion of the contract.'

Characteristics of a 'security deposit' under Division 99

31. For a payment to be considered a 'security deposit' for the purposes of Division 99, it should have the following characteristics:

- it is paid as an earnest (or security) to perform an obligation under a contract: see paragraphs 32 to 37.
- it is at risk of forfeiture upon failure to perform the obligation: see paragraphs 41 to 45.
- the amount to be forfeited is seen as reasonable to act as an earnest, and not as a part payment: see paragraphs 46 to 88.
- the contract, conduct and intent of the parties to the contract are consistent with the payment being a security deposit: refer paragraphs 38 to 40 and 44 to 45.

Deposit and part payment

32. In analysing contracts, the courts have commonly described a deposit as an 'earnest'[11] that is paid 'to bind the bargain'.[12] A payment made as an earnest has been said to provide 'a portion of something, given or done in advance, as a pledge of the remainder'.[13] This can be distinguished from paying the first instalment of a total price, which is to be paid over a period of time, that is, an initial instalment payment, or a part payment.

33. In *Howe v. Smith*[14] (*Howe's Case*), Fry, LJ described a deposit in the following terms:

> It is not merely a part payment, but is then also an earnest to bind the bargain so entered into, and creates by the fear of its forfeiture a motive in the payer to perform the rest of the contract.[15]

34. This view has been adopted by the Commissioner in Goods and Services Tax Ruling GSTR 2000/28,[16] in relation to standard land contracts, in which we take the view that:

> A deposit paid under a standard land contract serves two purposes.[17] If the contract goes through to completion, the deposit goes against the purchase price. But its initial purpose is as security for the performance of the contract.

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[11] *Howe v. Smith* (1884) 27 Ch D 89 per Cotton LJ at 95 and Fry LJ at 101, Jacobs J in *Brien v. Dwyer* (1978) 141 CLR 378 at 401; Lord Browne-Wilkinson in *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573 at 578.
[12] *Brien v. Dwyer* (1978) 141 CLR 378 at 401.
[13] *The Macquarie Dictionary*, 2001, rev. 3rd edn, The Macquarie Library Pty Ltd, NSW.
[14] (1884) 27 Ch D 89.
[15] (1884) 27 Ch D 89 at 101.
[16] GSTR 2000/28 Goods and services tax: attributing GST payable or an input tax credit arising from a sale of land under a standard land contract at paragraph 64.
[17] GSTR 2000/28 Goods and services tax: attributing GST payable or an input tax credit arising from a sale of land under a standard land contract at paragraph 65.

35. A payment that is not intended to act as a guarantee to ensure the contract is completed is not a security deposit.[18] It is not an incentive for the purchaser to perform its obligation under the contract. Such a payment is a part payment of the purchase price.

Example 2: Part payment is not a security deposit

36. *Laura purchases electrical equipment from a retailer for $550. The retailer tells Laura that if she enters into an instalment plan where she makes an initial payment of $100, and agrees to pay the balance in a month's time, she can take the equipment home that day.*

37. *The $100 that Laura pays is not a security deposit for purposes of Division 99. It is an initial instalment, or part payment, of the agreed purchase price.*

The deposit must be a deposit in more than name only

38. The fact that a certain payment is labelled a 'deposit' does not make it a deposit at law. Whether a particular payment is a deposit or a part payment is a question of fact determined by looking at the terms of the contract and the conduct of the parties to the contract.[19]

39. For example, the Commissioner is aware that, in the automotive recycling industry, customers are required to pay what is referred to as a 'core deposit' to purchase a reconditioned part. The core deposit is returned to the customer when the customer returns the worn part to the reconditioned parts supplier.

40. The core deposit, although labelled a deposit, is not a security deposit that is held to guarantee that the customer will complete the purchase of the reconditioned part. The purchase of the reconditioned part is considered to be a separate contract to that of the supply of the worn part. There are two separate supplies. In this case, the core deposit acts as an inducement for the customer to separately supply the worn part to the reconditioned parts supplier. In return the supplier refunds the core deposit to the customer upon receipt of the worn part.

Forfeiture

Deposit forfeited

41. A fundamental requirement of a security deposit is that the parties clearly understand at the commencement of the contract, either through an express term of the contract, or by implication of the conduct of the parties to the contract, that the deposit may be forfeited if the purchaser fails to complete the contract. If this understanding between the parties is not established, the payment is not a deposit.

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[18] Starke J in *McDonald and Another v. Dennys Lascelles Limited* (1933) 48 CLR 457 at 470, Dixon J at 478.

[19] Lord Dunedin in *Mayson v. Clouet and Another* [1924] AC 980 at 985-6. Also see *Howe's Case* per Cotton LJ at 95, Bowen LJ at 97 and Fry LJ at 101.

42. However, provided this clear understanding exists between the parties at the commencement of the contract, whether the forfeiture is actually enforced by the supplier upon the breach of some condition is irrelevant.

43. Comments made by Kay J *In re Levy's Trusts*[20] support this view. In this case he said:

> Clearly the word 'forfeit' means not merely that which is actually taken from a man by reason of some breach of condition, but includes also that which becomes liable to be so taken….It would be ridiculous to say that it was not forfeited because the forfeiture was not actually enforced…[21]

Deposit not forfeited

44. Even though a contract implies that forfeiture may occur, the parties to the contract may nevertheless have an understanding at the time the contract was entered into that the forfeiture will not be enforced. It is, therefore, necessary to look at both the forfeiture clause and the actual conduct of the parties, to determine whether there is a clear intention at the time of entering into the contract to forfeit the deposit upon a failure to perform the obligation.

45. For example, many standard agreements contain forfeiture clauses. However, corporate policy may be to maintain good customer relations by not enforcing the forfeiture of security deposits. This may indicate that there is no real intention or understanding between the parties at the time of entering into the contract that the amount is genuinely forfeitable in the event of failure of the purchaser to perform its obligations under the contract. It is, therefore, always a question of fact and degree whether or not, at the time of entering a contract, there is an intention to forfeit.

A deposit must be reasonable

46. For a deposit to act as an earnest, the amount of the deposit must be reasonable. If the amount is set too high, the courts exercising equitable jurisdiction will render the forfeiture of the deposit unenforceable.

[20] 30 Ch D 119 at 125.
[21] *In re Levy's Trusts* 30 Ch D 119 at 125.

47. The law relating to what is reasonable for a deposit to act as an earnest is summarised by Lord Browne-Wilkinson in *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd*[22] (*Dojap's Case*). He distinguished between a deposit that acts as an earnest, liquidated damages and deposits whose forfeiture will not be permitted:

> In general, a contractual provision which requires one party in the event of his breach of the contract to pay or forfeit a sum of money to the other party is unlawful as being a penalty, unless such provision can be justified as being a payment of liquidated damages being a genuine pre-estimate of the loss which the innocent party will incur by reason of the breach. One exception to this general rule is the provision for the payment of a deposit by the purchaser on a contract for the sale of land. Ancient law has established that the forfeiture of such a deposit (customarily 10 per cent. of the contract price) does not fall within the general rule and can be validly forfeited even though the amount of the deposit bears no reference to the anticipated loss to the vendor flowing from the breach of contract.
>
> This exception is anomalous and at least one textbook writer has been surprised that the courts of equity ever countenanced it: see *Farrand, Contract and Conveyance*, 4th ed. (1983), p. 204. The special treatment afforded to such a deposit derives from the ancient custom of providing an earnest for the performance of a contract in the form of giving either some physical token of earnest (such as a ring) or earnest money. The history of the law of deposits can be traced to the Roman law of arra and possibly further back still: see *Howe v. Smith* ... per Fry LJ. Ever since the decision in *Howe v. Smith*, the nature of such a deposit has been settled in English law. Even in the absence of express contractual provision, it is an earnest for the performance of the contract: in the event of completion of the contract the deposit is applicable towards payment of the purchase price; in the event of the purchaser's failure to complete in accordance with the terms of the contract, the deposit is forfeit, equity having no power to relieve against such forfeiture.
>
> However, the special treatment afforded to deposits is plainly capable of being abused if the parties to a contract, by attaching the label 'deposit' to any penalty, could escape the general rule which renders penalties unenforceable…

48. The courts will not normally intervene to provide relief to the purchaser from the automatic forfeiture of a reasonable deposit.

[22] [1993] AC 573 at 578 to 579.

Security deposits and liquidated damages

49. It has been suggested that security deposits are the same as liquidated damages.[23] In our view this is not the case. A liquidated damages clause sets out the amount of damages in advance and must be a genuine pre-estimation of the loss likely to be suffered by the injured party on termination,[24] an 'admitted….pre-assessment'.[25] The point of liquidated damages clauses is that they remove the necessity to pursue and prove a loss in a claim for breach of contract in the courts with consequent benefits of timeliness and a reduction in associated legal costs. Upon a breach, the injured party simply claims the agreed amount as a debt due and payable by the party in breach.

50. The purpose of a security deposit, on the other hand, is to act as an earnest to guarantee the performance of the purchaser's obligations under the contract. If the purchaser fails to perform the obligations under the contract, the deposit is simply forfeited at the option of the vendor. The issue of whether the amount forfeited is intended to be compensation or damages does not arise. The forfeiture comes about solely as a result of a failure to complete the obligation for which the deposit was security. Although forfeiture of the deposit will provide some relief to a vendor, it is our view that the forfeited amount is not intended to equate to the payment of liquidated damages.

51. This argument is strengthened when it is appreciated that a vendor is entitled to enforce forfeiture of a security deposit despite suffering no loss.[26] This is contrary to the purpose of liquidated damages. Further, Wolff, CJ in *Coates v. Sarich*[27] (*Coates Case*) held that a security deposit is not a guarantee or security for any particular amount of money, but rather a security that is to be retained by the vendor upon a breach of contract:

> I do not think it right to argue that the deposit is a security for large and small sums. I consider the proper approach is…the deposit is not security for any particular sum of money…but is an amount of money paid to be retained by the vendor as his absolute property if he rescinds the contract.

52. In addition, the forfeiture of a security deposit will not prevent the vendor from pursuing a claim in the courts for damages upon breach of the contract. This is in contrast to the payment of damages pursuant to a liquidated damages provision of a contract which is binding and enforceable upon the parties to the contract.

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[23] Mann, G & McMahon, J 'GST: real property real issues: Part III Security needed on security deposits', *Taxation In Australia*, 2005, issue 39 No. 9 April 2005 at page 472.
[24] Greig, DW and Davis, JLR 1987, *Law of Contract*, The Law Book Company at 1293.
[25] *Boucaut Bay Co Ltd v. The Commonwealth* (1927) 40 CLR 98 at 106.
[26] Lord Hailsham, LC *Linggi Plantations Ltd v. Jagatheesan* (1972) 1 MLJ 89 at 91.
[27] [1964] WAR 2 at 6.

53. Although the same broad principles derived from case law may be used to calculate what is reasonable for both liquidated damages and for security deposits (although, typically, a security deposit of 10% is usual and bears little or no relation to the potential loss), a security deposit and liquidated damages are, therefore quite different in function and serve very different purposes.

54. It is our view that the principles similar to those applied by the courts under the rules of equity may also be applied to determine a reasonable deposit under a purchase contract for the purposes of Division 99.

55. However, if the amount is unreasonable, it does not become a security deposit merely because the parties agree that the amount is subject to forfeiture and paid by the purchaser to secure its obligation under the contract to completion.[28]

What is a reasonable amount?

A purchase contract

56. The question of what is reasonable is discussed in the following cases.

57. In *Reid Motors Ltd v. Wood and Another*[29] (*Reid's Case)*, Mr Wood and another purchaser agreed to purchase cars from Reid Motors. At the time, New Zealand finance regulations required a purchaser to pay a deposit of at least 50% if the balance was to be financed under a hire purchase arrangement. Both plaintiffs paid at least this amount but subsequently rescinded their agreements to purchase the cars. Reid Motors then forfeited the deposits. Coates J made the following observation:

> In the normal course of business, a deposit as security for completion of the transaction is usually in the vicinity of 10 percent of the total price. It would be most unusual for a deposit to be as high as 50 percent of the contract price, let alone to exceed that figure.

[28] Wolff CJ in *Coates v. Sarich* [1964] WAR 2 at 6: '…when speaking about a 'deposit' it is not the fact that the parties call a sum of money the deposit that is conclusive; the circumstances of the bargain are the test.' See also page 15 of his judgement.

[29] (1978) 1 NZLR 319 at 327.

58. In *Dojap's Case* it was argued by the plaintiff and accepted, at least by the lower courts, that, as a 25% deposit was common practice in Jamaica at the time of the sale of the property at auction, it was considered reasonable in the circumstances. However, on appeal the Privy Council did not accept this. In his decision Lord Browne-Wilkinson said:[30]

> …In order to be reasonable a true deposit must be objectively operating as 'earnest money' and not as a penalty. To allow the test of reasonableness to depend upon the practice of one class of vendor, which exercises considerable financial muscle, would be to allow them to evade the law against penalties by adopting practices of their own.
>
> However although their Lordships are satisfied that the practice of a limited class of vendors cannot determine the reasonableness of a deposit, …. In their Lordships' view the correct approach is to start from the position that, without logic but by long continued usage both in the United Kingdom and formerly in Jamaica, the customary deposit has been 10 per cent. A vendor who seeks to obtain a larger amount by way of forfeitable deposit must show special circumstances which justify such a deposit.

59. What constitutes a reasonable amount for a deposit under a purchase contract depends upon the degree of risk to the vendor upon a breach or termination of contract by the recipient. If the vendor seeks a large security deposit, then that vendor will have to show that special circumstances exist.

60. In *Coates Case*,[31] in which the vendor justified a larger deposit, Wolff CJ stated that:

> …. the parties would have regard to risk which the vendor was taking in entrusting his property to the purchaser for such a long period of time. Besides the element of financial risk (personal to the purchaser), there can be the risk of disease, bad seasons, poor management, poor production results and economic depression, all of which may adversely affect the vendor's position: all factors which make it difficult if not impossible to forecast the vendor's position at that indefinite point in time when he may exercise his right to rescind, and so a higher deposit is justified. The vendor's personal position also has to be considered.

61. In *Hoobin, Re; Perpetual Executors and Trustees Association of Australia Ltd v. Hoobin*[32] (*Hoobin's Case*), O'Bryan, J noted that:

> … mere consideration of what percentage the deposit bears to the total purchase price is not enough. That is a relevant consideration, I have no doubt.

[30] [1993] AC 573 at 580.
[31] [1964] WAR 2 at 6, 7.
[32] [1957] ALR 932; [1957] VR 341 at 347.

62. O'Bryan J observed that the lengthy period of time of the contract could only lead to increased risks to the vendor. A deposit of only ten per cent could result in the estate suffering a huge loss. The trustee was, therefore, being no more than prudent and acting reasonably in requiring a substantially higher amount as deposit.[33]

63. With regard to contracts for land, Lord Browne-Wilkinson, in *Dojap's case,* noted that ancient law and custom had established a deposit of 10 per cent as being reasonable as an earnest. In our view a similar sized deposit could be equally reasonable in a sale of goods contract.[34]

64. We consider that cases such as *Coates Case* and *Hoobin's Case* are exceptional. It is our view that vendors seeking deposits in excess of 10% must be able to show that they are at a higher risk of significant losses in the event of default. In *Coates Case* and *Hoobin's Case* the major risks turned upon the length of time of the contract and the loss in value of the asset faced by the vendor in the event of mismanagement of an associated enterprise, neglect, breach of law and other associated factors.

65. We consider that other factors that may be taken into account in determining the reasonableness of an amount paid as a security deposit can include:

- unusual designs or sizes that render a completed product very difficult to sell in the event of default;
- the use of special materials that could not be used on other jobs;
- the purchase of highly specialized equipment which could only be used in the performance of the contract at risk;
- the length of time of the contract and the risk of loss or devaluation of the asset by neglect, illegal act, mismanagement or adverse conditions during that period; or
- other extraordinary conditions of the contract.

[33] The contract provided for a deposit of £20,000 and a balance by seven successive annual instalments of £1,500 each with a final balance of £30,000 at the end of the eighth year plus interest at 7% pa paid quarterly. The deposit represented approximately one third of the purchase price.

[34] See, for instance, *Dies and Another v. British and International Mining and Finance Corporation Limited* [1939] 1 KB 725 at 743, where Stable J noted that the rule had general application and also *Reid Motors Ltd v. Wood and Another* (1978) 1 NZLR 319 in particular 327.

66. These factors are not an exhaustive list. The reasonableness of any deposit is to be determined on the facts and circumstances of each case at the time the contract is entered into or the transaction is undertaken. It would also be relevant to take into consideration industry practices and norms, though this should be balanced against the vendor's capacity to impose an unreasonable deposit upon the purchaser (refer paragraph 58).

Example 3: Contract where a deposit is reasonable – no special circumstances

67. *The Forge is a boutique supplier of made to order wrought iron furniture. The company takes an order from Jim to supply a table and four chairs, which is one of their standard designs. The company would have little difficulty in selling the furniture elsewhere if Jim defaults on the order.*

68. *Jim pays a 10% deposit when he places the order. The order form states that the deposit is forfeited if Jim fails to collect the order within one month of manufacture.*

69. *The amount of 10% paid by Jim when the order is placed is reasonable as a deposit and is a security deposit to which Division 99 applies.*

Example 4: Contract where a deposit is reasonable – special circumstances

70. *Xena is a specialist dress maker from whom Alice has ordered her wedding dress. The material Alice has chosen is expensive and the design and colour of the dress are unusual. If Alice cancels her order for the wedding dress, Xena would find it difficult to find another buyer for the dress. As a consequence, Xena faces a significantly higher risk in the event of a default.*

71. *A sizeable deposit, approximately equal to one third of the total price of the dress, is paid by Alice when she places the order. This deposit is forfeited if Alice does not collect the dress. This deposit reflects the higher risk if the contract is not completed and, in the particular circumstance, is reasonable as a security deposit under Division 99.*

Example 5: Contract where a deposit is reasonable – special circumstances

72. *Precision Printhouse (Precision) has asked Exacta Print (Exacta), a printing company, to do some printing which involves the use of new printing technology. Exacta agrees because it sees an opportunity to enter an emerging market segment. However, to do so requires Exacta to invest in new plant which it currently has no use for within its existing operation.*

73. *Exacta is willing to take the risk of buying the new plant and develop the market. However, Exacta is exposed to significant cash flow problems in the short term if Precision fails to honour the contract.*

74. *Exacta requires a significant deposit as security, of the order of 25% of the total contract price, as a guarantee of the performance of the contract. The amount of the security deposit reflects the higher degree of risk that Exacta faces if the contract fails prior to completion. Because of the special circumstances, this deposit would be reasonable as a security deposit under Division 99.*

Example 6: Contract where a deposit is reasonable – special circumstances

75. *Maisie Maize (Maisie) sells her farm for $5 million to Cornelius Corn (Cornelius). The contract requires an initial deposit on signing of $1.5 million and settlement of the remaining amount in equal instalments over five years. Cornelius is allowed to occupy the farm in the intervening period and to carry on a farming enterprise.*

76. *During this period, Maisie's farm is subject to a number of risks which could severely impact upon its value. These include the risk that:*

- *Cornelius will employ poor land management practices;*
- *Cornelius will fail to instigate necessary fence repairs and weed maintenance or simply neglect the property;*
- *drought will ravage the property;*
- *flood will ruin vital pastures;*
- *political and economic conditions will impact severely on the property; or*
- *other reasons that could adversely affect the value of the property.*

77. *In the event that Cornelius is unable to settle on the property at the appropriate time, Maisie could suffer a large loss. Maisie is entitled to require a significant deposit as security, having regard to the risk which she is taking in entrusting the property to Cornelius for such a long period of time.*[35] *This deposit is reasonable, because of the special circumstances, as a security deposit under Division 99.*

A deposit that exceeds what is reasonable

78. The payment of an amount that exceeds what is reasonable is not an earnest and is not a security deposit for the purposes of Division 99.

[35] See *Coates v. Sarich* [1964] WAR 2 at 6.

79. If an amount is found to be unreasonably large for a deposit in its entirety, a question arises as to whether any part of the amount can be a deposit.

80. In *Dojap's Case*, it was found that as the contract provided for one sum equal to 25 per cent of the purchase price, the whole sum had to be paid back, less any damage the bank could actually prove as liquidated damages:

> If a deposit of 25 per cent. constitutes an unreasonable sum and is not therefore a true deposit, it must be repaid as a whole. The bank has never stipulated for a reasonable deposit of 10 per cent.: therefore it has no right to such a limited payment. If it cannot establish that the whole sum was truly a deposit, it has not contracted for a true deposit at all.[36]

Example 7: Payment not a security deposit as the amount is unreasonable

81. *Mary wants to purchase a new mattress from Furniture Pty Ltd. The salesperson describes some different types of mattresses and Mary chooses one that is priced at $660. The store is temporarily out of stock and needs to re-order.*

82. *The salesperson advises Mary that she must provide a deposit of $220 to Furniture Pty Ltd before her order will be taken. It is made clear to Mary that if she cancels the order prior to delivery, she will forfeit the entire $220. Mary places the order and pays the amount requested as a deposit.*

83. *The payment is one third of the total purchase price, which is considered unreasonably high in the circumstances given that there is little risk to Furniture Pty Ltd in reselling a standard stock item. It is not considered to be a deposit and as such is not a security deposit to which Division 99 applies.*

A reasonable amount for a hire only contract

84. The question of reasonableness of an amount as a security deposit under a hire only arrangement is a question of fact to be determined by looking at the arrangements entered into by the parties and the conduct of the parties to the agreement. The deposit clearly plays an additional role in a hire arrangement, being an inducement to ensure that the person hiring the goods both returns the goods and returns the goods without undue wear and tear. It would be expected that the deposit may be considerably higher than the actual hire fee. An entity wishing to obtain goods or equipment for a limited period under a hire only arrangement is not seeking to purchase the item and could not be said to be making a part payment towards the purchase of the item.

[36] [1993] AC 573 at 582.

85. The supplier, in hiring out goods or equipment, is taking a calculated risk that they may not be returned or be returned damaged.

86. We consider that the amount of a security deposit under a hire only contract is reasonable, if it acts as an inducement to return the hired goods without undue wear and tear and does not include the hire fee within it.

Example 8: Hire of equipment

87. *John hires some trestles for two weeks from Bob's Equipment Hire Services Ltd. He pays a hire charge of $110 which is subject to the ordinary GST attribution rules. He also pays $200 as a security deposit, knowing he will forfeit all or part of this sum if he does not return the trestles or does not return them in the same condition in which he took them.*

88. *The security deposit is not treated as consideration at the time John pays it to Bob's Equipment Hire Services Ltd. When John returns the trestles on time and in good condition, his deposit is refunded to him.*

Can the purchaser claim an input tax credit at the time the security deposit is paid?

89. Under the ordinary rules, a purchaser that makes a creditable acquisition[37] under a purchase contract is entitled to claim an input tax credit[38] for that acquisition when the consideration is provided.[39] A deposit, when paid, would ordinarily meet the definition of consideration[40] for a taxable supply.[41] This would mean that, if the other requirements of a creditable acquisition are met, a purchaser is entitled to claim input tax credits under the ordinary attribution rules at the time a deposit is paid.[42] However, under Division 99, a deposit is *not treated* as consideration for a supply until it is applied as consideration for that supply. When the deposit is paid, it is not to be treated as consideration for a supply.[43]

90. Therefore, a purchaser is not entitled to claim an input tax credit when the deposit is paid. At this time, the purchaser is not making a creditable acquisition for which there is an entitlement to input tax credits. The purchaser is entitled to claim an input tax credit under the ordinary attribution rules in section 29-10 if and when the deposit is *applied* as consideration for that supply.

91. The purchaser is entitled to claim an input tax credit for the remainder of the consideration that is actually paid or invoiced, other than the deposit to which Division 99 applies, under the basic attribution rules.

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[37] Section 11-5.
[38] Section 11-1.
[39] Unless on a basis other than cash where the invoice has issued.
[40] Sections 195-1 and 9-15.
[41] An assumption that the requirements of section 9-5 are met.
[42] Section 29-10.
[43] GSTR 2000/28 Goods and services tax: attributing GST payable or an input tax credit arising from a sale of land under a standard land contract at paragraph 68.

92. When the deposit is forfeited and is treated as consideration for a taxable supply, a purchaser is entitled to claim an input tax credit for an acquisition for which the security deposit is consideration, assuming that all the other conditions in section 11-5 are also met. The purchaser attributes the input tax credit from the creditable acquisition to the tax period in which the deposit is forfeited but must hold a tax invoice if the forfeited amount is greater than $55.[44]

Can the hirer claim an input tax credit at the time the security deposit is paid?

93. Similarly, when a hirer pays a security deposit, the deposit is not consideration for any supply at the time that the deposit is paid and, under Division 99, only treated as consideration for a taxable supply when it is either forfeited or applied as consideration for a supply. A hirer will not, therefore, be entitled to an input tax credit in respect of any security deposit unless it is retained either as consideration for a supply (for instance as payment against extra hire fees, damage or undue wear and tear) or is forfeited for some other reason.

94. As above, in paragraphs 89 to 92, and assuming that all the other conditions in section 11-5 are also met, the hirer attributes the creditable acquisition to the tax period in which the deposit is forfeited but must hold a tax invoice if the forfeited amount is greater than $55.

Timing and attribution under Division 99

95. If a payment satisfies all the requirements of a deposit held for the performance of an obligation, the effect of subsection 99-5(1) is to prevent a deposit from being treated as consideration for a supply until it is either forfeited or applied as part or all of the consideration for a taxable supply.[45] At this time, the deposit is treated as consideration for a supply.

96. Section 99-10 operates to ensure that the GST payable on a taxable supply for which the deposit constitutes all or part of the consideration is attributable to the tax period during which the deposit is either forfeited or is applied as part or all of the consideration for the taxable supply.[46]

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[44] Section 29-80, tax invoices are not required if the *value* of the supply does not exceed $50. The *value* is the GST exclusive amount of the supply which means that the corresponding GST inclusive amount is $55.

[45] Note: If the deposit is ultimately refunded to the recipient of the supply then the deposit amount will never be subjected to GST.

[46] Note that different rules under subsection 29-5(2) apply if the taxpayer accounts on a cash basis.

Deposit forfeited

97. We consider the effect of subsection 99-5(1) is that the nexus between the payment of the deposit and the original contracted or underlying supply is broken. This is achieved because, for the purposes of the GST Act, the payment of the deposit is not treated as consideration for any supply at the time that it is paid.

98. If the deposit is subsequently forfeited, it becomes consideration for a separate supply. It cannot be consideration for the underlying or original supply because this supply is not made.

99. Subsection 99-5(1) also acts to set the conditions for the consideration to be connected to the relevant supply. In the event that the deposit is forfeited because of a failure to perform the contracted obligation, paragraph 99-5(1)(a) operates to connect the deposit with a supply.[47] In this regard, when the deposit is forfeited by the purchaser or hirer, the supplier must rescind the contract, thereby surrendering their contractual rights in exchange for retaining the deposit.[48]

100. Thus, when the security deposit is forfeited, it becomes consideration for a taxable supply. Subsection 99-10(1) then provides the attribution rules for the GST payable on this supply. Under this section the GST payable on this supply is attributable in the tax period in which the deposit is forfeited. It should be noted that, provided the other conditions contained in section 9-5 are met, GST is payable on a forfeited deposit regardless of the nature of the underlying or original supply.

Example 9: Purchase contract – forfeiture of deposit

101. *Jo-Anne runs a small business. She places an order for $1,100 worth of prime quality beef for her restaurant. Prime quality beef is a special order item and her supplier, who is registered for GST, requires a security deposit of $110 before filling the order. Jo-Anne pays this amount when placing her order. It is a condition of sale that the deposit will be refunded to Jo-Anne if the supplier is unable to fulfil the order but that Jo-Anne will forfeit the deposit if she later decides to cancel the order. A week later, she cancels the order and forfeits her deposit.*

102. *The supplier has entered into an obligation to complete the contract and supply the beef to Jo-Anne. The supply of the beef would be a GST-free supply.*

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[47] Note in the event the original supply goes ahead and the deposit is applied as consideration paragraph 99-5(1)(b) operates to connect the deposit to the original supply.

[48] *Mayson v. Clouet and Another* [1924] AC 980 at 985, *McDonald and Another v. Dennys Lascelles Limited* (1933) 48 CLR 457 at 470 per Starke J. Note the supplier is giving up a right to enforce the terms contained in the contracts not an equitable right at common law to sue the purchaser for any loss suffered because of the breach.

103. *Upon forfeiture, the deposit is treated as consideration for a supply and this supply is a taxable supply. The supplier attributes GST payable of $10 on this taxable supply in the tax period in which the deposit is forfeited.*

104. *As the forfeited deposit is also consideration for a creditable acquisition, Jo-Anne has a claim for an input tax credit of $10 in the tax period in which the deposit is forfeited.*

Alternative argument

105. Some commentators have argued that Division 99 fails to capture forfeited deposits.[49] It is argued that when a sale fails to proceed, the vendor has not supplied anything under the contract and, in fact, has supplied nothing at all. The forfeiture of a deposit cannot be consideration for either the contracted supply or for any other supply. The forfeiture of a deposit, therefore, is said to be akin to the payment of damages in that it is out of scope of the Act.

106. We respectfully disagree with this view. We consider that the object of Division 99 is to ensure that the payment of the security deposit, which, at the time that it is paid, is intended to be both consideration for the supply and an earnest, does not trigger attribution under Division 29 for a taxable supply.

107. It is our view that Parliament's intention in introducing Division 99 was, in part; to ensure that forfeited deposits were subject to GST. This is reflected in the wording of paragraph 99-5(1)(a) which notes that the deposit is to be treated as consideration for a supply upon forfeiture and in the wording of paragraph 99-10(1)(a) which requires the forfeited deposit to be attributed to the tax period in which it becomes consideration for a taxable supply.

108. The EM that accompanied the original A New Tax System (Goods and Services Tax) Bill at paragraph 6.166 makes it clear that forfeited deposits should be subject to GST. At paragraph 6.169 the EM also makes it clear that the GST payable is attributed to the tax period in which the deposit is forfeited.

109. Finally section 15AA of the *Acts Interpretation Act 1901* states that the preferred construction of a provision is one that would promote the purpose or object underlying the Act. This type of construction is also supported by the common law.[50] Adopting the alternative view outlined in paragraph 105 would be contrary to this principle of statutory interpretation and would not give the intended effect to the provision.

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[49] Rowe, S 'Liquidated damages, terminated leases and forfeited deposits – Part II' *Australian GST Journa*l, 2004, Vol. 4, Issue 9 October 2004 at page 248.

[50] *Mills v. Meeking* (1990) 91 ALR 16; (1990) 169 CLR 214, *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408; 71 ALJR 294; 141 ALR 618 at 634-5, *Cooper Brookes (Wollongong) Pty Ltd v. Commissioner of Taxation* (1981) 147 CLR 297.

A hire only contract

110. Under a hire only contract, if a supplier requires a security deposit from a recipient before hiring the goods, we consider that the supplier makes a supply of the hire of goods. In doing so, the supplier makes a supply to the hirer, for which the security deposit would be part, all or even more than consideration, but for the operation of Division 99.

111. Under this type of contract, the supplier may have a deposit with a separate hire fee or a deposit only from which the hire fee is taken upon return of the hired goods.

112. If the recipient fails to return the hired goods, the recipient forfeits the deposit to the supplier. The deposit is taken to be consideration for a supply which is taxable.

Example 10: Hire only – deposit forfeited in subsequent tax period

113. *In March, Bob's Equipment Hire Services Ltd (BEHS) hires trestles to Nick. Nick pays $110 (inclusive of GST) for the hire upfront and $220 as a security deposit. BEHS attributes the GST payable of $10 on the taxable supply to which the hire charge relates in that this tax period but not the security deposit (because of the operation of Division 99).*

114. *In April, in the subsequent tax period, Nick fails to return the trestles and forfeits the security deposit of $220. Upon forfeiture, the deposit becomes consideration for a supply which is taxable. BEHS attributes, in this tax period, the GST liability of $20 for the taxable supply to which the forfeited deposit relates.*

A purchase contract where payments are made in instalments

115. When an initial payment that is intended to be consideration for a taxable supply is made under an instalment contract, all of the GST payable on that taxable supply is attributable to the tax period in which that payment is made.[51] Taxpayers who account on a cash basis attribute GST in the tax period in which all or part of the consideration is received but only to the extent of the amount received.

116. However, if the initial payment made in an instalment contract is intended to act as and actually is a security deposit, Division 99 defers attribution of that initial payment until that amount is either applied as consideration for the supply or is forfeited. The payment of the other instalment amounts triggers attribution of those amounts under the normal attribution rules contained in Division 29.

[51] For entities attributing on a non cash basis attribution occurs either at the time of the first instalment payment or when an invoice has issued which ever occurs earlier – see subsection 29-5(1).

117. This is consistent with the treatment afforded to deposits where the supply or acquisition is made for a period or on a progressive basis and such payments are being attributed in accordance with Division 156.[52] A security deposit that falls within Division 99, which is paid in conjunction with payments that are attributed in accordance with Division 156, only becomes attributable when it is either applied as part of the periodic or progressive payment or is forfeited.

Example 11: Instalment payment attributed on a non-cash basis

118. *Evergreen Blooms ('Evergreen'), a seedling grower, enters into a contract with Mortar Constructions Ltd ('Mortar') to propagate and deliver 10 000 punnets of mixed coloured flowers to Mortar in nine months time for the total consideration of $11,000 (inclusive of GST). Evergreen accounts on a non-cash basis.*

119. *Mortar agrees to pay Evergreen a security deposit of 10% on signing the contract (that is; $1,100) with the balance payable (that is; $9,900) in three instalments of 20% ($2,200) at the end of the 3 months, a further 30% ($3,300) at the end of 6 months and the balance of 40% ($4,400) on delivery. The security deposit is subject to forfeiture if Mortar fails to make any of the required instalment payments and is to be applied as part of the final consideration upon delivery of the punnets.*

120. *The security deposit is subject to Division 99.*

121. *At the end of 3 months, Evergreen receives the 20% instalment which is the first payment received which is not a security deposit. This payment triggers attribution of the GST payable on the $9,900 of consideration but not on the $1,100 security deposit which by the operation of Division 99 is not treated as consideration for the supply until it is either forfeited or is applied as part payment for the supply. The GST payable at the end of 3 months is $900 calculated as follows:*

- *$200 which is 10% × [10/11 × (20% × $11,000)] or 10% of $2,000; plus*
- *$300 which is 10% × [10/11 × (30% × $11,000)] or 10% of $3,000; plus*
- *$400 which is 10% × [10/11 × (40% × $11,000)] or 10% of $4,000.*

122. *When the security deposit is applied as consideration to the final instalment at the time of delivery of the trees, Evergreen also accounts for GST payable of $100 which is 10% × [10/11 ×(10% × $11,000)] or 10% of $1,000.*

[52] GSTR 2000/35 paragraphs 115 to 120.

123. *As Evergreen accounts on a non cash basis, attribution for the total consideration excluding the security deposit occurs at the time an invoice is issued to Mortar or the first instalment money is received which ever occurs earliest.*

Example 12: Instalment payment attributed on a cash basis

124. *If Evergreen accounts on a cash basis, it must account for GST payable of:*

- *$200 at the end of 3 months; plus*
- *$300 at the end of the 6 months; plus*
- *$400 at the time of delivery.*

125. *Evergreen must also account for GST payable of $100 on the security deposit when it is applied as consideration at delivery.*

Your comments

126. We invite you to comment on this draft Goods and Services Tax Ruling. Please forward your comments to the contact officer(s) by the due date.

Due date:	**16 September 2005**
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Detailed contents list

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Commissioner of Taxation
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Previous drafts:

Not previously issued as a draft

Related Rulings/Determinations:

GSTR 1999/1; GSTR 2000/28; GSTR 2000/35

Previous Rulings/Determinations:

GSTD 2000/1

Subject references:

- attribution
- cash basis verses non-cash basis accounting
- consideration
- progressive or periodic supplies
- security deposits
- supply
- taxable supplies

Legislative references:

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