GSTD 2012/1 - Goods and services tax: what are the goods and services tax consequences following the sale of residential premises that are subject to a lease?

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This ruling is being reviewed as a result of a recent court/tribunal decision. Refer to Decision Impact Statement: MBI Properties Pty Ltd v Commissioner of Taxation (Published 16 April 2014).

This document has changed over time. This is a consolidated version of the ruling which was published on *22 February 2012*

Generated on: 4 November 2026, 09:45:32 PM

Goods and Services Tax Determination

Goods and services tax: what are the goods and services tax consequences following the sale of residential premises that are subject to a lease?

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Background

1. This Determination concerns the following goods and services tax (GST) issues:

   (a) whether a supply of residential premises by way of lease remains an input taxed supply under section 40-35 of the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act)[1] following the sale of a reversion;

   (b) whether the purchaser of the reversion is entitled to input tax credits in connection with their acquisition of the reversion and other acquisitions; and

   (c) whether the purchaser of a reversion has an increasing adjustment under Division 135 if the sale of residential premises is, or is part of, the sale of a going concern.[2]

[1] All legislative references are to the GST Act unless otherwise indicated.
[2] The GST consequences for the purchaser of a reversion in commercial premises are addressed in Goods and Service Tax Determination GSTD 2012/2 *Goods and services tax: what are the goods and services tax consequences following the sale of commercial premises that are subject to a lease?*

2. In this Determination, when we refer to 'residential premises' we mean residential premises as defined in section 195-1 to be used predominantly for residential accommodation and that are not commercial residential premises. That is, premises the supply of which may be input taxed under sections 40-35 or 40-65.

3. In this Determination, the term 'reversion' refers to the freehold interest acquired when residential premises are sold subject to a lease. It also refers to the interest acquired when a leasehold estate is assigned subject to a sub-lease of residential premises. Both of these interests are a form of real property as defined in section 195-1.

4. This Determination confirms the views expressed in the Decision Impact Statement published by the Commissioner following the decision of the Full Federal Court in *South Steyne Hotel Pty Ltd v. Commissioner of Taxation* (*South Steyne*).[3]

Ruling

5. Following a sale of residential premises that are subject to a lease, there is a continued supply of the premises by way of lease which remains an input taxed supply under section 40-35.

6. The purchaser of residential premises is not entitled to an input tax credit under section 11-20 in respect of the purchase of the premises if and to the extent that it is intended that the lease will continue following the completion of the sale.

7. The purchaser is not entitled to input tax credits for acquisitions relating to the ongoing lease of the residential premises.

8. The purchaser has an increasing adjustment under Division 135, where residential premises subject to a lease are acquired through a supply of a going concern under section 38-325, or a GST-free supply of farm land under section 38-480, and the purchaser intends that the lease will continue.

9. In the following example, all of the entities are registered for GST.

Example – Sale of residential premises subject to a lease

10. *Property Ltd, as owner of all of the lots in a residential apartment complex in which each apartment is individually strata titled, leases the apartments to Management Pty Ltd under individual leases. Young Pty Ltd then purchases the lots from Property Ltd subject to the existing leases to Management Pty Ltd.*

11. *No GST is payable by Young Pty Ltd in relation to the leases because Young Pty Ltd does not make taxable supplies of the leases. Young Pty Ltd is not entitled to input tax credits in respect of the purchases of the apartments because the continuing leases remain input taxed after the sale. Additionally, Young Pty Ltd is not entitled to input tax credits for acquisitions associated with the purchases of the apartments, such as legal services, or for any acquisitions concerning the ongoing leases of the apartments, such as management services, insurance and maintenance.*

[3] [2009] FCAFC 155; (2009) 180 FCR 409; 2009 ATC 20-145; (2009) 74 ATR 41.

12. *The fact that Young Pty Ltd acquired the apartments subject to the existing leases indicates an intention at the time of the acquisition for the leases to continue. In the absence of evidence to the contrary, Young Pty Ltd would therefore have an increasing adjustment under Division 135 if it acquired the apartments as part of a GST-free supply of a going concern.*

Date of effect

13. This Determination applies both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
22 February 2012

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

Continuing supply of leased premises

14. Where real property is sold subject to a lease, the purchaser acquires the 'reversion' in that real property.[4] Under common law and real property legislation operating in each State and Territory,[5] the rights and benefits under the lease continue to exist and are enforceable between the purchaser and the lessee following the sale.[6]

15. Consequently, the lessee maintains the right to possession of the property and has the obligation to pay rent. The purchaser acquires the benefit of the right to the rent payable by the lessee and is bound to permit their continued enjoyment of the leased property.

16. No separate or new lease need be entered into between the purchaser of the reversion (as new owner of the real property) and the existing lessee to ensure the continued operation of the lease.

17. The Full Federal Court in *Westley Nominees Pty Ltd v. Coles Supermarkets Australia Pty Ltd*[7] *(Westley Nominees*) held that a purchaser of a reversion in commercial premises 'assumed the obligation [of the vendor] to honour the lease according to its terms and in that sense entered into an obligation to tolerate an act or situation and in consequence, made a 'supply' by virtue of s 9-10(2)(g)'.[8]

18. The Full Federal Court in *South Steyne* held that 'there is no supply' by the purchaser of a reversion in residential premises, declining an application for a declaration regarding the status of such a supply because in its view 'there was none'.[9] The judgements refer to the continuation of the supply by way of lease by the vendor as the grantor of the lease and to Division 156, Edmonds J indicating that its provisions 'prevent any unintended imbalance as between successive reversionary owners over the term of the lease'.[10]

19. We have been unable to fully reconcile the conclusion in *Westley Nominees* that the purchaser of the reversion makes a supply by tolerating the lessee's occupation of the premises with the conclusion in *South Steyne* that there is no supply by the purchaser of the reversion.

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[4] Butt, P 2010, *Land law*, 6th edn, Thomson Reuters, Sydney, p. 276.
[5] For example, see sections 117 and 118 of the *Conveyancing Act 1919* (NSW). Similar provisions are contained in real property legislation in the other States and the Australian Capital Territory and the Northern Territory.
[6] For example, see *Westley Nominees Pty Ltd v. Coles Supermarkets Australia Pty Ltd* [2006] FCAFC 115 at [13]. See also Butt, P 2010, *Land law*, 6th edn, Thomson Reuters, Sydney, pp. 375-8 and Bradbrook, AJ MacCallum, SV Moore AP and Grattan S 2011, *Australian Real Property Law*, 5th edn, Thomson Reuters, Sydney, pp. 643-644.
[7] [2006] FCAFC 115; (2006) 152 FCR 461; (2006) 2006 ATC 4363; (2006) 62 ATR 682.
[8] *Westley Nominees* at [22].
[9] *South Steyne* per Emmett J at [34] and Edmonds J at [77].
[10] *South Steyne* at [76].

20. However, we note that there is nothing in the judgements in either case to suggest that, because of a mere change in ownership of the reversion (where there is no merger of the reversionary and leasehold estates), the GST treatment of a lease would change. In *Westley Nominees*, the Court noted some odd results that would follow for commercial leases if that were so, and concluded that the legislation discloses an intention that 'the purchaser of the reversion is to be regarded as continuing to make the supply which its predecessor in title contracted to make'.[11] The judgements in both cases appear to indicate that Division 156 has a role in avoiding such outcomes.[12]

GST consequences

Input taxed treatment following the sale of leased residential premises

21. The judgements in *Westley Nominees* and *South Steyne* indicate that, upon the sale of a reversion, the supply by way of lease continues.

22. It would be extraordinarily anomalous if the GST treatment of leases were to change because of a mere change in ownership of the reversion and it would be expected that, if the Court intended such improbable outcomes, it would have referred to them in its judgements. As noted above, there is nothing in the judgements in either case to indicate that the GST treatment of the continuing lease supply would change.

23. Accordingly, we consider that there is a continuing supply of the residential premises to the lessee which remains input taxed under section 40-35, unaffected by the change in ownership in the reversion.

24. This construction finds support in the evident intent of the GST Act and the design of value added tax regimes internationally.[13] Both envisage the supply of leased residential premises being input taxed where, as is the case with the purchaser of a reversion, an entity is in receipt of residential rent.

25. Accordingly, the purchaser of a reversion in residential premises is not liable for GST in respect of the rent it receives.

Input tax credits

26. Under section 11-20, a taxpayer is entitled to input tax credits for any 'creditable acquisition' they make. Section 11-5 contains the requirements for an acquisition to be a creditable acquisition.

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[11] *Westley Nominees* at [20]-[21].

[12] *Westley Nominees* at [17] and *South Steyne* per Emmett J at [32]-[33] and Edmonds J at [76]. Division 156 in its terms appears to be concerned with attribution of liabilities and entitlements to tax periods, rather than which entity has the liability or entitlement. It also generally applies to entities which account for GST other than on a cash basis. The judgements in *South Steyne* and *Westley Nominees* do not elaborate on how Division 156 would apply in the context of input taxed supplies or taxpayers accounting on a cash basis.

[13] See paragraph 5.164 of the Explanatory Memorandum to the A New Tax System (Goods and Services Tax) Bill 1998, and Cnossen, S 1996, *Tax Law Design and Drafting*, vol. 1, Thuronyi V, Ch 7, International Monetary Fund, Washington D.C for an international comparison.

27. Paragraph 11-5(a) requires that, for an acquisition to be a creditable acquisition, the acquisition must be solely or partly for a 'creditable purpose'. Paragraph 11-5(b) requires that the supply of the thing, for which an input taxed credit is claimed, be a taxable supply. The supply to a purchaser of residential premises that are not 'new residential premises' as defined in section 40-75 at the time of sale, is not a taxable supply.[14]

28. Paragraph 11-15(2)(a) provides that an acquisition is not for a creditable purpose to the extent that the acquisition relates to making supplies that would be input taxed.[15] A lease of residential premises is an input taxed supply under section 40-35.

29. For the reasons indicated above, a change in ownership of leased residential premises does not cause the supply of those premises to cease being input taxed.

30. Ordinarily entities carrying on an enterprise are entitled to input tax credits where they do not make input taxed supplies and the acquisitions are not of a private or domestic nature. Noting the discussion above in relation to the *Westley Nominees* and *South Steyne* cases, whether or not a purchaser of a reversion makes a supply to the lessee, the continuing supply to the lessee is input taxed.

31. In the particular circumstances of the acquisition of the reversion in residential premises, where the rights and obligations run with the land, we consider that the acquisition of the reversion and acquisitions relating to the continuing lease of the premises, such as management services, repairs and maintenance, have a relationship, which is not insubstantial,[16] with the making of a continuing supply that is input taxed.

32. Consequently, the purchaser of the reversion in residential premises is not entitled to input tax credits for the acquisition of the reversion or acquisitions relating to the continuing supply of the residential premises by way of lease.

Division 135

33. The supply of a going concern is GST-free where the requirements of subsection 38-325(1) are satisfied. Additionally, section 38-480 makes the supply of land on which a farming business has been carried on GST-free in certain circumstances.

34. Under subsection 135-5(1) the recipient of a supply of a going concern or a supply of farm land to which section 38-480 applies has an increasing adjustment if the condition in paragraph 135-5(1)(b) is satisfied.

35. For this to occur, paragraph 135-5(1)(b) requires that the recipient intends that some or all of the supplies, made through the enterprise to which the supply of the going concern or farm land relates, will be supplies that are neither taxable supplies nor GST-free supplies.

36. In the absence of contrary evidence, the fact that residential premises are acquired subject to an ongoing lease indicates an intention for the lease to continue.

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[14] This is because the supply of the premises is input taxed under section 40-65.

[15] Goods and Services Tax Ruling GSTR 2006/4 *Goods and services tax: determining the extent of creditable purpose for claiming input tax credits and for making adjustments for changes in extent of creditable purpose*, sets out the Commissioner's view on section 11-15 in more detail.

[16] *HP Mercantile Pty Ltd v. Commissioner of Taxation* [2005] FCAFC 126; (2005) 143 FCR 553; 2005 ATC 4571; (2005) 60 ATR 106; per Hill J at [38]-[39] and [73].

37. For the purposes of paragraph 135-5(1)(b), we therefore regard the acquisition of leased residential premises under a GST-free supply of a going concern or a GST-free supply of farm land as relating to the continuing supply of those premises under the existing lease.

38. Since the ongoing supply under the lease is input taxed, it is neither a taxable supply nor a GST-free supply. Consequently, if the sale of residential premises subject to a lease is GST-free under section 38-325 or section 38-480, the purchaser has an increasing adjustment under Division 135 where the lease is to continue. The amount of the adjustment is calculated in accordance with subsection 135-5(2).

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

GSTD 2012/2; GSTR 2006/4; TR 2006/10

Subject references:

- creditable acquisition
- creditable purpose
- goods and services tax
- GST input tax credits & creditable acquisitions
- GST lease and real property
- GST sale of real property
- GST residential premises
- GST residential rents
- increasing adjustment

Legislative references:

- ANTS(GST)A 1999 9-10(2)(g)
- ANTS(GST)A 1999 11-5
- ANTS(GST)A 1999 11-5(a)
- ANTS(GST)A 1999 11-15
- ANTS(GST)A 1999 11-15(2)(a)
- ANTS(GST)A 1999 11-20
- ANTS(GST)A 1999 38-325
- ANTS(GST)A 1999 38-325(1)
- ANTS(GST)A 1999 38-480
- ANTS(GST)A 1999 40-35
- ANTS(GST)A 1999 40-65
- ANTS(GST)A 1999 40-75
- ANTS(GST)A 1999 Div 135
- ANTS(GST)A 1999 135-5(1)
- ANTS(GST)A 1999 135-5(1)(b)
- ANTS(GST)A 1999 135-5(2)
- ANTS(GST)A 1999 Div 156
- ANTS(GST)A 1999 195-1
- Conveyancing Act 1919 (NSW) 117
- Conveyancing Act 1919 (NSW) 118
- TAA 1953

Case references:

- HP Mercantile Pty Ltd v. Commissioner of Taxation [2005] FCAFC 126; (2005) 143 FCR 553; 2005 ATC 4571; (2005) 60 ATR 106
- South Steyne Hotel Pty Ltd v. Federal Commissioner of Taxation [2009] FCAFC 155; (2009) 180 FCR 409; 2009 ATC 20-145; (2009) 74 ATR 41
- Westley Nominees Pty Ltd v. Coles Supermarkets Australia Pty Ltd [2006] FCAFC 115; (2006) 152 FCR 461; 2006 ATC 4363; (2006) 62 ATR 682

Other references:

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- Bradbrook, AJ MacCallum, SV Moore AP and Grattan S 2011, Australian Real Property Law, 5th edn, Thomson Reuters, Sydney
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- Decision Impact Statement South Steyne Hotel Pty Ltd NSD 97/2009

ATO references

NO: 1-3JOZE2K
ISSN: 1443-5179
ATOlaw topic: Goods and Services Tax ~~ Miscellaneous rules ~~ leases
Goods and Services Tax ~~ Property and construction ~~ real property