GSTR 2006/2 - Goods and services tax: deposits held as security for the performance of an obligation

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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 ruling for the purposes of section 105-60 of Schedule 1 to the **Taxation Administration Act 1953**. You can rely on the information presented in this document which provides advice on the operation of the GST system.*

*[**Note:** This is a consolidated version of this document. Refer to the Tax Office Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]*

What this Ruling is about

1. This 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 a deposit held as security for the performance of an obligation. For the purposes of this Ruling, this will be referred to as a security deposit.

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

- the meaning of a security 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 security deposit.

3. This Ruling also explains the special rules for the attribution of GST on taxable supplies relating to security deposits.

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

Date of effect

5. This Ruling explains our view of the law as it applied from 1 July 2000. You can rely upon this Ruling on and from its date of issue for the purposes of section 37 of the *Taxation Administration Act 1953*. 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.

6. If this Ruling conflicts with a previous private ruling that you have obtained, this 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 this 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 issue of this later Ruling. Similarly, you are not liable to repay an amount overpaid by the Commissioner as a refund.

Note: The Addendum to this Ruling that issued on 11 July 2007, explains our view of the law as it applied from 1 July 2007. You can rely upon the Addendum on and from its date of issue for the purposes of section 105-60 of Schedule 1 to the *Taxation Administration Act 1953*.

Note 2: The Addendum to this Ruling that issued on 24 June 2009 explains the Commissioner's view of the law as it applies both before and after its date of issue. You can rely upon the Addendum on and from its date of issue for the purposes of section 105-60 of Schedule 1 to the *Taxation Administration Act 1953*.

Background

7. 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]

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

9. However, when an amount is paid as a security deposit, the special rules set out in Division 99 apply.[3]

10. 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.

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

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***.

11. For the purposes of this Ruling, references to a taxable supply and to a creditable acquisition assume that the respective requirements of section 9-5 and section 11-5 are met.

Previous Rulings

12. This Ruling finalises Draft Ruling GSTR 2005/D1 Goods and services tax: deposits held as security for the performance of an obligation, which replaced Goods and Services Tax Determination GSTD 2000/1 Goods and services tax: is the scope of Division 99 of the *A New Tax System (Goods and Services Tax) Act 1999* limited to holding deposits? GSTD 2000/1 was withdrawn with effect from the date of issue of the Draft Ruling, being 3 August 2005. You can rely upon GSTD 2000/1 until 3 August 2005. 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 3 August 2005.

Ruling and Explanation

The Purpose of Division 99

13. Subsection 99-5(1) prevents a security deposit 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 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 security deposit is forfeited or applied as all or part of the consideration for a supply. The EM[5] contemplates at least two types of security deposit arrangements to which this Division applies.

15. One type of arrangement involves a contract for the purchase of real property, goods or services (a 'purchase contract'), where the recipient pays a deposit to secure their obligations under the contract.

16. The other type of arrangement in which a security deposit may be paid involves a contract for the hire of goods[6], where the supplier requires a deposit (or bond) to be paid to secure the payment of periodic rental instalments and/or the return of the goods on time and in good condition. In this Ruling, we will refer to lease, rent, hire-only and bailment arrangements as 'hire arrangements'.

17. Under either arrangement, the failure to perform the secured obligation risks forfeiture of the deposit.[7]

Characteristics of a 'security deposit' under Division 99

18. To fall within the provisions of Division 99, the amount 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.

19A. In *Federal Commissioner of Taxation v. Reliance Carpet Co Pty Ltd* [2008] HCA 22; 2008 ATC 20-028; 68 ATR 158 (*Reliance Carpet*) the High Court noted at paragraphs 22 to 27 of the decision that the term 'deposit' had several aspects. These aspects include that a deposit: could be counted towards the payment of the purchase price; be brought into account in assessment of damages; be a token provided by the purchaser as 'an earnest to bind the bargain'; and provide a form of security for performance by the purchaser.

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

- be held as a security for the performance of an obligation: see paragraphs 21 to 30;
- the contract, conduct and intent of the parties to the contract must be consistent with the payment being a security deposit: see paragraphs 31 to 50;

[5] Paragraphs 6.164 to 6.169.
[6] Note: a reference to a hire of goods is also a reference to a hire of real property.
[7] 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).

- be at risk of forfeiture upon failure to perform the obligation: see paragraphs 51 to 64; and
- be a reasonable amount:[8] see paragraphs 65 to 108.

Held as security

21. For Division 99 to apply, 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 that is 'held'.

22. A deposit is 'held' when it is paid to a person in the capacity of stakeholder. Normally, in commercial situations, the supplier will be the holder of the security deposit. It makes no difference who holds the deposit, provided it is 'held' for the benefit of the supplier to secure the recipient's obligations.

23. An amount ceases to be a security deposit when that amount is applied as consideration, or forfeited, regardless of whether it is held by the supplier or a third party at that time. However, there are occasions where a deposit may be released without it being considered to be applied.[9]

24. The accounting treatment may be evidence that 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.

Example 1: Deposit held by a stakeholder

25. *Dale enters into a contract to purchase an apartment from Wayne. By mutual agreement with Wayne, Dale pays a forfeitable deposit to a third party, Tim, to hold on trust awaiting settlement. Tim is not paid any fees or commission from this deposit until it is either applied at settlement or is forfeited upon a breach of contract by Dale.*

26. *The deposit is a security deposit for the purposes of Division 99. The deposit is held by Tim as a stakeholder for the benefit of Wayne until it is applied at settlement.*

[8] Security deposits may be a flat or fixed sum rather than a variable percentage amount. The deposit, however, must still be a reasonable amount in the circumstances to be treated as a security deposit for the purposes of Division 99.

[9] 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, 69, and in particular, 86 and 87.

Performance of an obligation

27. A security deposit is held to secure, or to act as a guarantee, for the performance of the recipient's obligations under a contract.[10] The nature of the obligations is usually dependent upon the intentions of the parties, as evidenced by the terms and conditions (express or implied) of a contract and the conduct of the parties.[11]

28. In a purchase contract, the supplier ordinarily seeks to secure, by way of a security deposit, the recipient's obligations to complete the contract and pay the contracted purchase price.[12] Upon the recipient performing its obligations, the supplier is obliged either to apply the deposit for the recipient's benefit, usually by applying it towards the total purchase price of the supply, or by returning it to the recipient.

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

30. Under a hire arrangement, the recipient's secured obligations are typically satisfied by returning the hired goods in a satisfactory condition at the agreed time and paying any additional or outstanding hire fees.[13] The supplier either returns the deposit upon the return of the goods, or keeps all or part of the deposit if the goods are not returned, returned late, or returned damaged.

Deposit and part payment

31. In analysing contracts, the courts have commonly described a deposit as an 'earnest'[14] that is paid 'to bind the bargain'.[15] A payment made as an earnest has been said to be 'a portion of something, given or done in advance as a pledge of the remainder'.[16] This can be distinguished from paying the first instalment of the total price in a purchase contract, which is to be paid over a period of time, that is, an initial instalment payment, or a part payment.

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[10] GSTR 2000/28 at paragraph 64.
[11] Cotton LJ, Bowen LJ, and Fry LJ in *Howe v. Smith* (1884) 27 Ch D 89 at 92, 97, 101.
[12] 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.' Lord Macnaghten in *Soper v. Arnold and Another* (1889) 14 App Cas 429 at 434 commented that '…if there is a case in which a deposit is rightly and properly forfeited it is … when a man enters into a contract … without taking the trouble to consider whether he can pay for it or not.'
[13] Taylor PWE, Tribunal Chairman in *John George Leigh t/a Moor Lane Video v. The Commissioners of Customs and Excise* (1990) 5 BVC 757; 2 VATTR 59 at 63 stated that: 'In any hiring…there will be an obligation on the hirer to return the item hired. Normally, where the hiring is for a specified period, the general obligation to return will arise at the end of that period'. For a further discussion and explanation refer to 64-66.
[14] *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; [1993] 2 All ER 370; [1993] 2 WLR 702.
[15] *Brien v. Dwyer* (1978) 141 CLR 378 at 401.
[16] *The Macquarie Dictionary*, 2001, rev. 3rd edn, The Macquarie Library Pty Ltd, NSW.

32. In *Howe v. Smith*[17] (*Howe*), 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.[18]

33. This view has been adopted by the Commissioner in Goods and Services Tax Ruling GSTR 2000/28,[19] in relation to standard land contracts. In that Ruling, the Commissioner takes the view that:

> A deposit paid under a standard land contract serves a number of purposes. 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.

34. A payment that is not intended to act as an earnest to ensure the contract is completed is not a security deposit.[20]

Example 2: Part payment is not a security deposit

35. *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 instalment payment of $100, and agrees to pay the balance in a month's time, she can take the equipment home that day. The payment does not act to secure the performance of any obligation and is not at risk of forfeiture.*

36. *The $100 that Laura pays is not a security deposit for the purposes of Division 99. It is a part payment of the agreed purchase price.*

The deposit must be a deposit in more than name only

37. The fact that a certain payment is labelled a 'deposit' does not make it a security deposit at law. Whether a particular payment is a security deposit is a question of fact, determined by looking at the terms of the contract and the intention of the parties to the contract.[21]

38. For example, in the automotive recycling industry, recipients may be required to pay what is referred to as a 'core deposit' to purchase a reconditioned part. The core deposit is returned to the recipient when the recipient gives the worn part to the reconditioned parts supplier.

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[17] (1884) 27 Ch D 89.
[18] (1884) 27 Ch D 89 at 101.
[19] GSTR 2000/28 at paragraph 64.
[20] Starke J in *McDonald and Another v. Dennys Lascelles Limited* (1933) 48 CLR 457 at 470, Dixon J at 478. Lord Macnaghten in *Soper v. Arnold and Another* (1889) 14 App Cas 429 at 434 emphasises in discussing the two purposes of a deposit that: '… if the purchase is carried out it goes against the purchase-money – but its primary purpose is this, it is a guarantee that the purchaser means business…'.
[21] Lord Dunedin in *Mayson v. Clouet and Another* [1924] AC 980 at 985-6. Also, see *Howe* per Cotton LJ at 95, Bowen LJ at 97, and Fry LJ at 101.

39. The core deposit, although labelled a deposit, is not a security deposit that is held to guarantee that the recipient 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 recipient to supply, separately, the worn part to the reconditioned parts supplier. In return the supplier refunds the core deposit to the recipient upon receipt of the worn part.

Pre-contract deposits are not security deposits

40. A pre-contract deposit may be paid by a potential recipient to demonstrate the potential recipient's keen interest in entering into a purchase contract or hire arrangement. Because there is no contract the 'pre-contract deposit' is held on trust for a specified purpose but remains the beneficial property of the potential recipient.

41. A so called 'deposit' may also be paid by a potential recipient under an agreement, prior to entering into a purchase contract or hire agreement, in return for rights of pre-emption, or for a covenant.

42. In the circumstances described in paragraphs 40 and 41, even though these payments are often called deposits, the Commissioner does not regard them as security deposits for the purposes of Division 99. Neither payment has the characteristics of a security deposit as outlined in this Ruling.[22]

43. The pre-contract deposit referred to in paragraph 40 is not a security deposit because it remains the property of the potential recipient. At the time of payment it is not paid in respect of a supply that is to occur between the parties. It is not subject to forfeiture, and does not secure any contractual obligations between the parties, because, at the time of payment, none are in existence.

44. However, this type of pre-contract deposit may later become all or part of a security deposit if a purchase contract or hire arrangement is entered into. As explained by Aickin J in *Brien v. Dwyer*:[23]

> It appears clear in principle that if payment were made in advance of the formation of the written contract, it would be held by the estate agent for the purchaser until the contract was signed by both parties or separate parts exchanged: *Sorrell v. Finch* [1977] AC 728. Upon exchange of parts or contemporaneous signatures it would become 'the deposit' and as such would be held by the estate agents in accordance with the terms of the contract.

45. The 'deposit' referred to in paragraph 41 is not a deposit at all but may be consideration for a separate supply under a pre-emption or covenant agreement. The 'deposit' is not a security deposit as it is not paid to act as earnest to secure any obligations between the parties but rather is paid for the pre-emption or covenant rights.

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[22] In particular see paragraph 20 of this Ruling for a list of the relevant characteristics.
[23] (1978) 141 CLR 378 at 406.

Example 3: Pre-contract deposit not a security deposit

46. *Hajar wants to buy real property. She approaches the real estate agent who suggests she pays $10,000 as a good faith gesture before approaching the owner.*

47. *No contract is entered into for the purchase of the property when this payment is made and the supplier is free to enter contracts with other parties or otherwise deal with the property. It is agreed between Hajar and the agent that the payment will form the initial deposit if a contract is entered into. It is also agreed that, until a contract is entered into, the pre-contract deposit remains Hajar's property and she can withdraw it at any time.*

48. *Hajar's pre-contract deposit is not a security deposit for the purposes of Division 99. If a contract for sale is entered into, and the pre-contract deposit becomes a deposit to secure Hajar's obligations under that contract, it becomes a security deposit for the purposes of Division 99.*

Example 4: Consideration for a covenant not a security deposit

49. *William needs to lease business premises but is unable to sign a lease agreement until his business plan is approved by his financier. He approaches the owner of suitable premises who agrees not to lease the property to anyone else for one week provided William pays $550.*

50. *The payment of $550 is not a security deposit for the purposes of Division 99. It is consideration for the taxable supply of a covenant or undertaking of not leasing the property to anyone else.*

Forfeiture

Deposit subject to forfeiture

51. A fundamental requirement of a security deposit is that the parties to a contract clearly understand at its commencement, either through an express term, or by implication, that the deposit may be forfeited if the recipient fails to perform the secured contractual obligations.[24] It is necessary, in the Commissioner's view, that there be a mutual intention by the contracting parties to make the deposit subject to forfeiture. If this intention is not present, the deposit is not a security deposit.

[24] Denning LJ in *Stockloser v. Johnson* [1954] 1 QB 476 at 490 equates a deposit with a forfeiture clause: 'But when there is a forfeiture clause or the money is expressly paid as a deposit (which is equivalent to a forfeiture clause), then the buyer who is in default cannot recover the money at law at all.'

52. The important consideration is the intention or understanding between the parties to the contract at its commencement. Therefore, if, at the time that the deposit was paid it was intended and clearly understood that the deposit was subject to forfeiture upon the failure of the recipient to perform their obligations, the deposit is a security deposit.[25]

53. If this clear understanding exists between the parties at the commencement of the contract, it is not relevant whether the forfeiture is actually enforced by the supplier upon the breach of some term or condition.[26]

Deposit not subject to forfeiture

54. Even though a contract may state that the deposit is subject to forfeiture, the parties to the contract may have an understanding at the time the contract was entered into that the forfeiture will not be enforced. The understanding may be reached through additional bargaining at the time of entry into the contract, or through the previous conduct of the parties. If such an understanding can be discerned having regard to these and other factors, the deposit is not a security deposit.

55. It is necessary to examine the terms and conditions of the contract, in particular, the forfeiture clause, and the intention of the parties at the time of entering into the contract, to determine whether the deposit is subject to forfeiture.

56. Although many standard contracts contain forfeiture clauses, to maintain good customer relations, commercial practice may be to not enforce forfeiture of the security deposit. This may indicate that there is no real intention, at the time of entry into the contract, that the deposit is genuinely forfeitable if the recipient fails to perform their contractual obligations.

57. Where forfeiture is a term or condition of the contract, the Commissioner will accept, *prima facie,* that the deposit is at risk. However, if the commercial practice is made known to the recipient at the time of entry into the contract, this may lead to the conclusion that the parties have openly bargained to remove the forfeiture clause.

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[25] This is subject to the other characteristics of a security deposit listed in paragraph 20 being met.

[26] Kay J *In re Levy's Trusts* (1885) 30 Ch D 119 at 125 commented on the meaning of the word 'forfeit'. 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…'.

Example 5: Forfeiture clause varied through understanding between parties – deposit not a security deposit

58. *Nick is a purchasing officer with a firm specialising in office refurbishment. He buys office equipment from Customised Office Systems (Customised) but frequently cancels orders at short notice due to changes in project specifications and designs.*

59. *For each project, Nick enters into a contract to purchase the project equipment and pays a security deposit.*

60. *Although Customised has a forfeiture clause in its standard contracts, Nick, historically, has had all deposits refunded on cancelled orders. Nick considers that he is a valued customer and has an understanding, through previous discussions with staff, of the store's commercial practice to refund deposits to valued customers.*

61. *Since Nick and the supplier have an understanding that deposits are not subject to forfeiture, the deposit paid by Nick is not a security deposit for the purposes of Division 99.*

Example 6: Forfeiture clause removed from contract – deposit not a security deposit

62. *European Cars Pacifica (Pacifica) enters into a standard contract to sell a luxury motor vehicle to Joseph. Joseph pays a deposit of 10% of the purchase price. The standard contract contains a forfeiture clause.*

63. *Joseph specifically questions the forfeiture clause and requests that it be removed from the contract. Pacifica agrees.*

64. *As the contract has been varied to exclude the possibility of forfeiture, the deposit paid by Joseph is not a security deposit to which Division 99 applies.*

A deposit must be reasonable

65. For a deposit to be a security deposit for the purposes of Division 99, the amount of the deposit must be reasonable. If the amount is set too high, the courts exercising equitable jurisdiction will not regard the amount paid as a deposit.

66. The law relating to what is reasonable for a deposit to act as a security deposit is summarised by Lord Browne-Wilkinson in *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd*[27] (*Dojap*). He distinguished between a deposit that acts as an earnest and deposits for which 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.

What is a reasonable amount for a purchase contract?

67. It is the Commissioner's view that the principles applied by the courts under the rules of equity are equally applicable to determine what is reasonable under a purchase contract for a deposit to be a security deposit for the purposes of Division 99.

68. If the amount is unreasonable, it is not a security deposit merely because the parties label the amount a deposit or agree that it is to be subject to forfeiture.[28]

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[27] [1993] AC 573 at 578 to 579.

[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

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

70. In *Reid Motors Ltd v. Wood and Another*[29] (*Reid)*, 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 purchasers paid at least this amount but subsequently repudiated their agreements to purchase the cars. Reid Motors rescinded the contract and treated the deposits as forfeited. The court found that the deposits were not reasonable and not subject to forfeiture. 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.

71. In *Dojap*, the Privy Council did not accept that a 25% deposit was a reasonable deposit, although it was common practice in contracts for sale of land in Jamaica. The larger deposit was to cover the prepayment of certain expenses rather than any increased risks faced by vendors. 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. [emphasis added]

72. What constitutes a reasonable amount for a deposit under a purchase contract depends upon the degree of risk to the supplier upon a breach or termination of contract by the recipient. If the supplier seeks a large security deposit, then that supplier needs to demonstrate that special circumstances exist.

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conclusive; the circumstances of the bargain are the test.' See also Hale J at page 15 of his judgement.

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

[30] [1993] AC 573 at 580.

73. In *Coates v. Sarich*[31] *(Coates),* in which the supplier 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.

74. In *Hoobin, Re; Perpetual Executors and Trustees Association of Australia Ltd v. Hoobin*[32] (*Hoobin*), 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.

75. O'Bryan J observed that the lengthy period of time of the contract could only lead to increased risks for the supplier. A deposit of only 10% 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 a deposit.[33]

76. With regard to contracts for land, Lord Browne-Wilkinson, in *Dojap,* noted that ancient law and custom had established a deposit of 10% as being reasonable as an earnest. Consistent with the comments by Coates J in *Reid* above, the Commissioner's view is that a similar sized deposit could be equally reasonable in a sale of goods contract as a security deposit for the purposes of Division 99.

77. The Commissioner considers that cases such as *Coates* and *Hoobin* are exceptional. It is the Commissioner's view that for a deposit that exceeds 10% in a purchase contract to be accepted as a security deposit to which Division 99 applies, suppliers must be able to show that they are at a higher risk of significant losses in the event of default. In *Coates* and *Hoobin,* the major risks turned upon the length of time of the contract and the loss in value of the asset faced by the supplier in the event of mismanagement of an associated enterprise, neglect, breach of law and other allied factors.

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[31] [1964] WAR 2 at 6-7.
[32] [1957] ALR 932; [1957] VR 341 at 347.
[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. Note: Prior to forfeiture the amount of the deposit was revised down to £15,000.

78. The Commissioner considers that the factors that may be taken into account in determining the reasonableness of an amount paid as a security deposit for a purchase contract include:

- duration of the contract and the time over which payment is to occur, as this may increase the risk of loss or devaluation of the asset by neglect, illegal act, mismanagement or adverse conditions during that period;
- uniqueness of the goods or the process involved in the supply, including:
  - 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; and
  - the purchase of highly specialized equipment which could only be used in the performance of the contract at risk;
- the vulnerability of the goods to loss in value; or
- other extraordinary conditions of the contract.

79. 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 that the contract is entered into. It is also relevant to take into consideration industry practices and norms, although this should be balanced against the supplier's capacity to impose an unreasonable deposit upon the recipient (refer to paragraph 71).

Example 7: Contract where a deposit is reasonable – no special circumstances

80. *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.*

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

82. *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 8: Contract where a deposit is reasonable – special circumstances

83. *Xena is a specialist dressmaker 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.*

84. *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. In the special circumstances, the deposit is reasonable and is a security deposit.*

Example 9: Contract where a deposit is reasonable – special circumstances

85. *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. To fulfil this order, Exacta needs to invest in new plant, for which it has no use in its existing operation.*

86. *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.*

87. *Exacta requires a significant deposit, in 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. In the special circumstances, this deposit is reasonable as a security deposit.*

A reasonable amount for a hire arrangement

88. The question of reasonableness for a security deposit under a hire arrangement is a question of fact. It is to be determined by looking at the arrangement entered into and the intention and conduct of the parties at the time of entry into the contract.

89. As the deposit in a hire arrangement is security against the late return of, non-return of, or damage to the hired goods, it may be reasonable for the deposit to be considerably higher than an amount which may be reasonable under a purchase contract. This is because the supplier carries a risk of the goods being damaged or the goods not being returned by the recipient.

90. What is reasonable as a deposit in a hire arrangement is always dependant upon the facts and circumstances of each particular arrangement. It is the Commissioner's view that an amount 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 10: Hire of equipment

91. *John hires some trestles, valued at $400, for two weeks from Bob's Equipment Hire Services Ltd (BEHS). He pays a hire charge of $110, which is subject to the ordinary GST attribution rules. He also pays $220 as a security deposit knowing that all or part of this sum will be forfeited if he does not return the trestles.*

92. *In the circumstances the deposit is reasonable and is a security deposit.*

93. *When John returns the trestles on time and in good condition, his deposit is refunded to him. The return of the deposit does not have any GST consequences for either BEHS or John.*

A deposit that exceeds what is reasonable

94. 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.

95. In *Dojap*, where the contract provided for a deposit of one sum equal to 25% of the purchase price, it was found that the deposit had to be paid back less any amount the bank could prove as 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.[34]

96. If an amount is unreasonable, it is not a security deposit. Division 99 has no application to this amount and it will be subject to the normal attribution rules contained in Division 29. The amount may be consideration for a supply at the time that it is paid, for example, as a part payment under a purchase contract. If the amount is consideration for a supply, the GST payable on the taxable supply is attributed to the tax period in which the payment is made.[35] If the amount, or any part of it, is refunded to the recipient, an adjustment event may arise.[36]

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[34] [1993] AC 573 at 582.
[35] Section 29-5.
[36] Division 19.

Example 11: Payment not a security deposit as the amount is unreasonable

97. *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.*

98. *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.*

99. *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. GST payable on the supply is attributed under Division 29 and not Division 99. If the supplier accounts on a non-cash basis, the GST payable of $60 is attributable to the tax period in which the amount is received. If the supplier accounts on a cash basis, the GST payable of $20 is attributable to the tax period in which the amount is received.*

100. In some instances, the competitive nature of the market place has encouraged commercial practices to be developed that seek a large deposit in an effort to 'lock' a recipient into a contract. Sometimes, this means that the full price is requested and paid. In other instances, substantial amounts, often a third or more, are requested and paid.

101. A feature of these arrangements is that the recipient is given the impression that failure to complete the contract will render the deposit liable to forfeiture. This impression may be conveyed to the recipient even though the supplier's commercial practice is to refund all amounts if the recipient cancels the contract and requests a return of the deposit.

102. In these cases, a purpose of seeking a large deposit is to discourage the recipient from seeking a better deal from a competitor. The apparent rationale is that the amount of the deposit at risk is greater than any additional discount that may be obtained from a competitor. The recipient, therefore, feels compelled to complete the bargain.

103. If the amount of a deposit is set to counter possible discounts from competitors and discourage a recipient from seeking a better deal, the deposit is not a security deposit. It is the Commissioner's view, in these cases, that the deposit bears no relationship to the risk to the supplier. Rather, it is designed to act '*in terrorem*'[37] or as a penalty clause, forcing the recipient to complete the bargain for fear of losing the deposit.

Example 12: Payment not a security deposit as the amount is unreasonable

104. *Cheryl wants to purchase a food processor. She visits a local discount dealer, Discount Deals, who suggests a standard off-the-shelf model that is currently their 'advertised special'.*

105. *As the price of $369 seems good value, Cheryl agrees to buy the food processor. However, since sales have exhausted stocks, Discount Deals advises Cheryl that it will not have new stock until the next week. Discount Deals tells Cheryl that it will honour the special price provided that Cheryl immediately orders the food processor from them. Initially, the sales representative asks Cheryl to make the full payment but later accepts a deposit of one third of the purchase price, being $123. Cheryl is informed that she will forfeit her deposit if she fails to complete the purchase.*

106. *Later that day, Cheryl finds the same food processor on sale with a competitor, Ever Cheap, for $309 which is $60 less than Discount Deals' advertised special. However, because she fears losing her deposit at Discount Deals, she does not cancel her Discount Deals' order.*

107. *The food processor is a standard item of stock. Discount Deals is unlikely to suffer any loss if Cheryl cancels her order. The deposit that Cheryl paid to Discount Deals does not operate as a security to guarantee Cheryl's performance of the contract. Rather, it is unreasonable and is more in the nature of a penalty. It acts 'in terrorem' to ensure that Cheryl completes the purchase from Discount Deals and does not cancel the order in favour of a better deal from a competitor.*

108. *The deposit is not a security deposit for the purposes of Division 99. If Discount Deals accounts on a non-cash basis, it is required to attribute GST payable on the $369 in the tax period in which the $123 deposit is taken.*

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[37] Lord Browne-Wilkinson, delivering the judgment of their Lordships in *Dojap* at 579, said: 'The question therefore is whether or not the deposit of 25 per cent in this case was reasonable as being in line with the traditional concept of earnest money or was in truth a penalty intended to act in terrorem.'

Security deposits are not liquidated damages

109. [Omitted.].[38]

110. However, in the Commissioner's view, the forfeiture of a security deposit is not a payment in the nature of damages or liquidated damages. 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;[39] it is an 'admitted….pre-assessment'.[40] A liquidated damages clause removes the necessity to pursue and prove the amount of a loss in a claim for breach of contract in the courts with consequent benefits of timeliness and reduction in associated legal costs. Upon a breach, the injured party claims the agreed amount as a debt due and payable by the party in breach.

111. The purpose of a security deposit, on the other hand, is to act as an earnest to guarantee the performance of the recipient's obligations under the contract. If the recipient fails to perform their obligations under the contract, the deposit is forfeited at the option of the supplier. The forfeiture is a consequence of the recipient's failure to perform the secured obligations. Although forfeiture of the deposit provides some relief to a supplier, if it is reasonable, it need not bear any relationship to the amount of any estimated or actual loss or damage suffered.[41]

111A. In *Reliance Carpet* the High Court considered the proposition that a deposit held as security for the performance of a purchaser's obligations under a contract when forfeited for failure of the purchaser to perform its obligations is a payment in the nature of damages. The Court stated at paragraph 24:

> The argument fails at proposition (i). Subject to the possibility of a successful application by the purchaser under s49(2) of the Property Law Act[16], a deposit may be forfeited by a purchaser irrespective of the vendor having sustained any loss sounding in damages for breach of contract…

112. Santow J in *Terry v. Permanent Trustee Australia Ltd*[42] also noted that a deposit which is not extravagant in amount is not required to be a genuine pre-estimate of the supplier's loss.

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[38] [Omitted.]
[39] Greig, DW and Davis, JLR 1987, *The Law of Contract*, The Law Book Company Limited, Sydney, at 1293.
[40] *Boucaut Bay Company Limited (in Liquidation) v. The Commonwealth* (1927) 40 CLR 98 at 106.
[41] *Dojap* [1993] AC 573 at 578; [1993] 2 All ER 370; [1993] 2 WLR 702, *Linggi Plantations Ltd v. Jagatheesan* [1972] 1 MLJ 89 at 93.
[42] (1995) 6 BPR 14091 at 14107.

113. Santow J referred to the analysis of Holland J in *Barrett v. Beckwith (No. 2)*[43] who distinguished a payment of a deposit from that of a sum of liquidated damages in this way:

> In my view, a deposit under a contract for the sale of land is not to be regarded in the same light as a provision for payment of a sum of liquidated damages for default. Whilst it may serve the purpose of covering the vendor for losses and costs if the purchaser defaults and the vendor becomes entitled to forfeit the deposit, it has another important purpose, as has been held more than once, namely, to serve as a guarantee by the purchaser of the purchaser's performance of the contract.[44]

114. Barwick CJ in *NLS Pty Ltd v. Hughes*[45] also noted that it cannot be said that, if an agreed amount of deposit is not a penalty, then it must be a pre-estimate of damages:

> But it is not correct, it seems to me, that, if the amount agreed be not a penalty, it must be a pre-estimate of damages. So to reason overlooks the very case with which we are called upon here to deal, namely, the case of the deposit of a sum which is neither a penalty nor a pre-estimate of damages but an earnest of performance which, on default, may be retained and credited against the damage suffered. That the sum is not punitive is obvious. That it is not a pre-estimate of damages is to my mind just as obvious.[46]

115. This argument is strengthened when it is appreciated that a supplier is entitled to enforce forfeiture of a security deposit despite suffering no loss.[47] Further, in *Coates,*[48] Wolff CJ held that a security deposit is not a guarantee or security for any particular amount of money, but rather a security that may 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.[49]

116. In addition, the forfeiture of a security deposit does not prevent the supplier from pursuing a claim in the courts for damages upon breach of the contract.[50]

117. Although forfeited security deposits are taken into account in the assessment of damages payable, this does not alter the characterisation of the initial payment. If it is intended that the amount is to be liquidated damages, it is the Commissioner's view that it is not a security deposit for the purposes of Division 99.

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[43] (1974) 1 BPR 9439.
[44] (1974) 1 BPR 9439 at 9444.
[45] (1966) 120 CLR 583.
[46] (1966) 120 CLR 583 at 589.
[47] Lord Hailsham LC in delivering the judgement of the Board in *Linggi Plantations Ltd v. Jagatheesan* [1972] 1 MLJ 89 at 91-93.
[48] [1964] WAR 2.
[49] [1964] WAR 2 at 6.
[50] *Mayson v. Clouet and Another* [1924] AC 980 at 985.

118. The object of damages is, as far as possible, to compensate the injured party for any loss suffered and return them to the same position that they would have been in if the contract had not been entered into.[51] If the amount forfeited as a security deposit is not taken into account in calculating damages, then the supplier may be placed in a better position than they would have been in, had the contract not been entered into.

119. Although a forfeited deposit can be taken into account in the calculation of loss in an action for damages, the right to its retention bears no relationship to the existence of any loss, an award for damages, or the parties' rights to undertake an action for damages for the breach.

120. In the Commissioner's view, a deposit, or a forfeited deposit, is not in the nature of damages when paid or forfeited, and for this reason, remains within the scope of the GST Act.

Forfeiture of a deposit is consideration for a supply

Purchase contracts

121. The Commissioner considers that subsection 99-5(1) has the effect of breaking any nexus that may exist between the payment of a security deposit and the originally arranged or intended underlying supply.[52] This is because, for the purposes of the GST Act, the deposit is not treated as consideration for a supply until the circumstances in subsection 99-5(1) apply.[53]

122. The term 'supply' is defined broadly in subsection 9-10(1) to mean 'any form of supply whatsoever'.[54] Subsection 9-10(2) without limiting subsection 9-10(1) lists inclusive examples of a supply.

123. In *Reliance Carpet* the High Court endorsed comments made earlier by the Administrative Appeals Tribunal in *Reliance Carpet Company Pty Ltd v. Federal Commissioner of Taxation* [2006] AATA 486; 2006 ATC 2206; (2006) 63 ATR 1001 that there is a supply made by a vendor upon entering into a contract for the sale of land. The Court said at paragraph 37:[55][56]

> The AAT correctly applied that definition to the Contract as follows:
>
> > In the circumstances it may fairly be said that upon execution of the contract the applicant made a supply in that, in terms of s9-10(2)(g) of [the Act], it 'entered into an obligation' to do the things it was bound to do under the contract...

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[51] See, for instance, *Haines v. Bendall* (1991) 172 CLR 60 at 63.
[52] Note that in the event that the contract is completed and the deposit is applied as consideration, paragraph 99-5(1)(b) operates to connect the deposit with the supply it is applied against.
[53] [Omitted.]
[54] *Shaw v. Director of Housing & Anor (No. 2)* 2001 ATC 4054; (2001) 46 ATR 242 at paragraph 13 and *Saga Holidays Ltd v. FC of T* [2005] FCA 1892 at paragraph 48.
[55] [Omitted.]
[56] [Omitted.]

124. The High Court reasoned that the payment of the deposit by the purchaser was in connection with the supply made by the vendor. The High Court said at paragraph 33:

> The payment of the deposit by the purchaser to the taxpayer was 'in connection with' a supply by the taxpayer, within the meaning of the definition of 'consideration' in s9-15(1)(a) of the Act…the payment of the deposit obliged the parties to enter into the mutual legal relations with the executory obligations and rights laid out in the Contract. Those legal relations were directed to the completion of the Contract by conveyance of the property to the purchaser by the taxpayer upon payment by the purchaser...

124A. The Commissioner is of the view that the High Court's reasoning in *Reliance Carpet* is equally applicable to cases involving the forfeiture of deposits on contracts for the provision of goods and services generally.

125. Furthermore, the intention of Division 99 is in part; to ensure that forfeited deposits are treated where appropriate as subject to GST when the forfeiture occurs.[57] This interpretation is supported by the words of paragraph 99-5(1)(a) which states that a deposit is not to be treated as consideration for a supply unless it is forfeited. This means that a deposit must be treated as consideration for a supply upon forfeiture.

126. The supply, for which the forfeited deposit is consideration, constitutes a taxable supply under section 9-5 if it meets the requirements in paragraphs (b) to (d) of that section and is not otherwise GST-free or input taxed.

126A. A supply contemplated to be made under a contract may meet the description of a supply that is GST-free or input taxed. A security deposit may be paid in relation to the contract. If the deposit is forfeited, it is consideration for a supply the supplier makes when it enters into a contract consisting of the obligations it undertakes and the consequent rights it grants. The Commissioner considers that paragraphs 9-30(1)(b) and 9-30(2)(b) would be applicable in a case where a security deposit is forfeited in relation to a contract where the contemplated supply would have been GST-free or input taxed. Broadly those provisions state that a supply consisting of a right to receive another supply that would be GST-free or input taxed is also GST-free or input taxed, as the case requires.

[57] The EM in paragraph 6.166 indicates that forfeited deposits should be subject to GST. Also, at paragraph 6.169 the EM notes that the GST payable on the forfeited deposit is attributable to the period in which the deposit is forfeited.

Example 13: Purchase contract – forfeiture of a deposit on a supply that would have been GST-free

127. *Jo-Anne runs a small business and is registered for GST. 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 local 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 decides to cancel the order. A week later, she cancels the order and the supplier informs her that her deposit will be forfeited.*

128. *The supply of beef would have been a GST-free supply. Upon forfeiture, the deposit is treated as consideration for a supply of a right to receive a supply of beef under the contract. This supply is a GST-free supply because it involves the supply of a right to receive a supply of beef which would have been GST-free.*

Example 13A: Purchase contract – forfeiture of a deposit on a supply that would have been a taxable supply

128A. *If the local supplier had instead contracted to supply cardboard boxes to Joanne the supply of the boxes would have been a taxable supply. Upon forfeiture by Joanne, the deposit she paid is treated as consideration for a taxable supply by the local supplier of a right to receive the supply of boxes. The supplier attributes GST payable of $10 on this taxable supply in the tax period in which the deposit is forfeited.*

Example 13B: Purchase contract – forfeiture of a deposit on what would have been a mixed supply

128B. *Assume the local supplier would have made a mixed supply consisting of both beef and cardboard boxes under a single contract for which Joanne paid a single deposit. Upon forfeiture of the deposit the supplier would determine on a reasonable basis the amount of the forfeited deposit relevant to the supply of a right to Joanne to receive the cardboard boxes under the contract. The supplier would attribute GST payable on this portion of the forfeited deposit. The supplier would not attribute any GST for that portion of the forfeited deposit applicable to the contemplated GST-free supply of beef.*

Hire arrangements

129. To constitute a security deposit, the hire arrangement must allow for the retention by the supplier of some or all of the deposit. In the event of the recipient's failure to perform its obligations upon breach, the security deposit may be treated as forfeited, or applied as consideration for a supply, depending upon the terms, conditions and circumstances of the hire arrangement.

130. If, directly or indirectly in accordance with the arrangement, the security deposit is applied in full or in part to satisfy the cost of any specifically identifiable supply, including for example, additional rental, repairs, or extraordinary wear and tear, the Commissioner considers that any amount so applied will constitute consideration for that supply. Any amount of the security deposit which is refunded is not treated as consideration for a supply.

131. If the full amount of the security deposit is forfeited under the arrangement, without reference to its application or apportionment against the cost of a particular supply as described in paragraph 130, the Commissioner considers that the forfeited deposit is consideration for the supplier's entry into obligations upon the hire arrangement being made. This is the same treatment as for purchase contracts (refer to paragraphs 121 to 128B of this Ruling). An example of this is when a supplier treats the contract as at an end and the deposit as forfeited because the recipient has failed to return the hired goods.

Example 14: Hire arrangement – deposit consideration for a supply in subsequent tax period

132. *In March, Bob's Equipment Hire Services Ltd (BEHS) (who lodges on a monthly non-cash basis) hires trestles to Tamara and to Bill for the same period and under the same conditions. Both recipients pay $110 (inclusive of GST) for the hire charge upfront and $220 as a security deposit. BEHS attributes the GST payable of $10 on each taxable supply to which the hire charge relates in the March tax period but not the security deposit (because of the operation of Division 99).*

133. *In April, Tamara fails to return the trestles within the required time and cannot be contacted. BEHS treats the contract as at an end and retains the security deposit of $220. BEHS attributes the GST liability of $20 in the tax period in which the deposit is forfeited.*

134. *In April, Bill also fails to return the trestles within the required time but Bill advises BEHS that he will return the trestles in May. In May, Bill returns the trestles. Upon the return of the trestles in May, BEHS calculates the additional hire fee and applies part of the deposit as payment. BEHS applies $110 of the security deposit towards additional hire charges and refunds the remaining $110 to Bill. BEHS attributes the GST liability of $10 in the May tax period when the deposit is applied for the new supply of trestles.*

Example 15: Hire arrangement – deposit applied as consideration for a supply which is not taxable

135. *With her sub-tenant leaving, Edwina can no longer afford to rent the unit where she lives. In fact, she is a month in arrears with her rent and owes $1,200.*

136. *She gives notice to the landlord who retains her $1,200 bond. This amount is applied to the outstanding rent for the supply of residential premises as per her rental contract. However, since the supply of the residential premises is input taxed,*[58] *no GST is payable.*

Example 16: Hire arrangement – deposit forfeited

137. *Stan's 4WD Hire operates on an island popular with four wheel drive enthusiasts. However, the beach on the west side of the island is treacherous. Stan makes it a condition of hire that his vehicles are not to enter the western beach area.*

138. *If Stan discovers a vehicle in the western beach area, the hire arrangement is rescinded and the deposit is forfeited. The fees for the remaining hire are returned. The initial hire charge was a taxable supply by Stan.*

139. *The forfeited deposit is consideration for Stan's entry into obligations at the time the hire arrangement was made. The forfeited deposit is consideration for a taxable supply. The GST payable is attributable to the tax period in which the deposit is forfeited.*

Timing and attribution under Division 99

140. The tax period to which GST payable on a taxable supply for which a security deposit is consideration is attributable depends upon a number of factors. This includes whether the supplier has issued an invoice to the recipient or whether the recipient has made an additional instalment payment. This is also relevant in determining the period in which the recipient may claim an input tax credit. This is explained below.

141. 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 all or part of the consideration for a taxable supply.[59] When that occurs, the deposit is treated as consideration for a supply.[60]

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[58] See Subdivision 40-B – Residential rent.
[59] Note: If the deposit is ultimately refunded to the recipient of the supply, then the deposit is not subject to GST.
[60] Note: GSTR 2000/28 at paragraphs 86 and 87 deal specifically with the early release of deposits under section 27 of the *Sale of Land Act 1962* (Vic).

142. Subsection 99-10(1) 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 in which the deposit is either forfeited or is applied as all or part of the consideration for the taxable supply.[61]

Attribution of instalment payments subsequent to an initial security deposit

143. When an initial payment that is intended to be consideration for a taxable supply under an instalment contract, is made, all of the GST payable on that supply is attributable to the tax period in which that payment is made.[62] Entities that account on a cash basis attribute GST to the tax period in which all or part of the consideration is received, but only to the extent of the amount that is received.[63]

144. If the initial payment made in an instalment contract qualifies as a security deposit for the purposes of Division 99, then Division 99 defers attribution of the GST payable.

145. However, an instalment payment made after the initial security deposit means that the GST payable on the supply becomes attributable under the basic attribution rules in Division 29.

146. Taxpayers who account on a non-cash basis attribute GST on all of the consideration for the taxable supply, in the tax period in which this instalment is received. The GST payable for that tax period includes the GST payable on the security deposit.[64]

147. Entities that account on a cash basis attribute GST to the extent that the consideration is received for the taxable supply in the tax period in which the subsequent amount is paid.[65] The security deposit, however, is not applied as consideration in this tax period. Attribution of the security deposit occurs when the deposit is either forfeited or applied as consideration for a supply.

Example 17: Instalment payment – supplier attributes on a non-cash basis

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

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[61] Note that to the extent an entity is in receipt of the deposit different rules under subsection 29-5(2) apply if the taxpayer accounts on a cash basis.
[62] For entities attributing on a non-cash basis attribution occurs either at the time of the first instalment payment or when an invoice issues which ever occurs earlier. See subsection 29-5(1).
[63] Note: for the treatment of supplies made on a progressive or periodic basis refer to Division 156 and GSTR 2000/35.
[64] Paragraph 29-5(1)(a).
[65] Paragraph 29-5(2)(b).

149. *Mortar pays 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.*

150. *The deposit is a security deposit for the purposes of Division 99.*

151. *At the end of 3 months, Evergreen receives the 20% instalment which is the first payment received after the security deposit. This payment triggers attribution of the GST payable on the full consideration for the taxable supply by virtue of paragraph 29-5(1)(a).*

152. *The GST is payable on the consideration of $11,000, being the $9,900 instalment consideration and the $1,100 security deposit. The GST payable of $1,000 is attributed to the tax period in which the 20% instalment payment is received.*

Example 18: Instalment payment – supplier attributes on a cash basis

153. *If Evergreen, from Example 17 above, accounts on a cash basis, it must account for GST in the tax periods in which it receives each instalment. GST is attributable thus:*

- *$200 in the tax period in which the 3 month instalment of $2 200 is paid;*
- *$300 in the tax period in which the 6 month instalment of $3 300 is paid; and*
- *$400 in the tax period in which the final instalment of $4 400 is made.*

154. *Evergreen must also account for GST payable of $100 on the security deposit in the tax period in which it is applied as consideration (at delivery).*

Attribution when an invoice issues with the payment of a security deposit

155. The attribution rule in subsection 29-5(1) has two limbs. The first attributes the GST payable to the tax period in which any of the consideration is received. The second attributes the GST payable to the tax period in which an invoice is issued (before any consideration is received).[66]

156. The special rule contained in Division 99 has no application where an invoice is issued by a supplier who accounts on a non-cash basis. In this case, the supplier is required to account for GST on the full amount of the taxable supply in the tax period in which the invoice is issued.[67]

Example 19: Invoice issued

157. *Assuming the same facts as Example 17, except that Evergreen upon receipt of the security deposit issues Mortar an invoice for the total consideration of $11,000 (inclusive of GST) noting that $1,100 has been received as a security deposit.*

158. *Although the security deposit is subject to Division 99, the issue of the invoice triggers attribution of the GST payable on the full consideration for a taxable supply.*

159. *The GST is payable on the consideration of $11,000 being the $1,100 security deposit and the $9,900 instalment consideration. The GST payable is $1,000 and is attributed to the tax period in which the invoice is issued.*

[66] For the meaning of an invoice refer to GSTR 2000/34 Goods and services tax: what is an invoice for the purposes of the *A New Tax System (Goods and Services Tax) Act 1999* ('GST Act')?
[67] Refer to subsection 29-5(1)(b).

Can a recipient of a supply claim an input tax credit at the time the security deposit is paid?

Purchase contracts

160. Under the ordinary rules, a recipient that makes a creditable acquisition[68] is entitled to claim an input tax credit[69] for that acquisition when the consideration is paid.[70] A security deposit, when paid, may ordinarily meet the definition of consideration[71] for a taxable supply. This would mean that a recipient is entitled to claim input tax credits under the ordinary attribution rules at the time a security deposit is paid.[72] However, under Division 99, a security deposit is *not* treated as consideration for a supply until it is applied as consideration for that supply. Payment of the security deposit does not, therefore, trigger attribution of an input tax credit under paragraph 29-10(1)(a) or paragraph 29-10(2)(b).[73] Therefore, a recipient is not entitled to claim an input tax credit when the security deposit is paid.

161. When the security deposit is forfeited and is treated as consideration for a taxable supply, the recipient is entitled to claim an input tax credit for the creditable acquisition for which the security deposit is consideration. The recipient attributes the input tax credit to the tax period in which the deposit is forfeited but must hold a valid tax invoice if the forfeited amount is greater than $82.50.[74]

Example 20: Purchase contract – claiming input tax credits

162. *Assume the facts from Example 13A at paragraph 128B of this Ruling where the contemplated supply is a taxable supply of cardboard boxes. The forfeited deposit is consideration for a creditable acquisition. Jo-Anne can make a claim for an input tax credit of $10 in the tax period in which the deposit is forfeited.*

163. The recipient may attribute an input tax credit[75] for the security deposit under the ordinary attribution rules in section 29-10 if:

- an additional payment is made to the supplier; or
- the recipient who accounts on a non-cash basis obtains an invoice from the supplier.

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[68] Section 11-5.
[69] Section 11-1.
[70] Unless on a basis other than cash where the invoice has issued. This also assumes that a tax invoice is also held at the time that the BAS in which the claim is made is lodged.
[71] Sections 195-1 and 9-15.
[72] Section 29-10.
[73] See, also, GSTR 2000/28 at paragraph 68.
[74] Section 29-80, tax invoices are not required if the value of the supply does not exceed $75. The value is the GST exclusive amount of the supply which means that the corresponding GST inclusive amount is $82.50.
[75] Note: You are required to hold a valid tax invoice when the GST inclusive amount is $82.50 or more.

164. Accordingly, if the recipient makes a further payment in addition to the initial deposit, or obtains an invoice, and the recipient accounts on a non-cash basis, the recipient may attribute an input tax credit for a creditable acquisition under the basic rules. This includes the input tax credit applicable to the security deposit despite the fact that it has not yet been forfeited or applied.

165. If the recipient accounts on a cash basis, the recipient may attribute an input tax credit to the extent that the consideration is paid in the relevant tax periods. The security deposit is not treated as consideration until it is applied as consideration or forfeited. This can be a time other than when the further payment is made.

Hire arrangements

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

Cooling off periods

167. A cooling off period is that period of time after signing a contract during which legislation grants a right to a recipient to rescind a contract. When a recipient rescinds a contract within the cooling off period, the deposit paid by the recipient is refunded, although, frequently, the legislation also allows for part of that deposit to be forfeited.

168. GSTR 2000/29 Goods and services tax: attributing GST payable, input tax credits and adjustments and particular attribution rules made under section 29-25,[76] deals with attribution of payments associated with a cooling off period. However, it does not deal with situations where the recipient of the supply decides to exercise their right under the cooling off period not to proceed with the purchase and forfeits part of their security deposit.

[76] See paragraphs 74-78, 109-118 and Schedule 2.

169. The GST consequences of returning a security deposit in these circumstances are:

- the return of any monies back to the recipient is not consideration for any supply and therefore has no GST consequences; and
- any amount that is forfeited is consideration for a taxable supply. The amount forfeited, and only that amount, is attributable in the tax period in which it was retained or forfeited as a result of the recipient exercising their right, under the cooling off period, to cancel the contract.

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Commissioner of Taxation
5 April 2006

Previous draft:

GSTR 2005/D1

Related Rulings/Determinations:

GSTR 1999/1; GSTR 2000/28; GSTR 2000/29; GSTR 2000/34; 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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