GSTR 2004/D2 - Goods and services tax: GST consequences of the assumption of vendor liabilities by the purchaser of an enterprise

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This document has been finalised.

Draft Goods and Services Tax Ruling

Goods and services tax: GST consequences of the assumption of vendor liabilities by the purchaser of an enterprise

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Preamble

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

What this Ruling is about

1. This Ruling is about the application of the *A New Tax System (Goods and Services Tax) Act 1999* ('GST Act') to an entity that purchases an enterprise ('purchaser') where some, or all, of the liabilities of the vendor are assumed by the purchaser.

2. This Ruling discusses whether the purchaser of an enterprise makes a supply to the vendor by agreeing to assume liabilities of the vendor as part of the acquisition of the enterprise. The Ruling also addresses the supply of an enterprise by the vendor, and the consideration for that supply.

3. This Ruling considers a variety of liabilities of the vendor that may be assumed by the purchaser as part of the supply of the overall enterprise, that is, all those things that make up an enterprise. The mechanisms to assume a liability are discussed along with the respective GST treatment.

4. In some circumstances, the supply of an enterprise may constitute the supply of a going concern for the purposes of section 38-325 of the GST Act. Goods and Services Tax Ruling GSTR 2002/5, which deals with when a 'supply of a going concern' is GST-free, explains section 38-325. This Ruling should be read in conjunction with GSTR 2002/5.

5. This Ruling does not apply to a transaction, the substance of which is an assumption of another entity's liability in return for payment, where there is no supply of an overall enterprise.[1]

6. The examples included at the end of this Ruling present a variety of different scenarios where liabilities are assumed as part of a supply of an enterprise. The interpretations outlined in this Ruling are applied in these examples.

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

Date of effect

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

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

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

[1] This transaction is known as a debt defeasance arrangement. This Ruling does not apply to a debt defeasance arrangement that occurs independently to the sale of an enterprise.

Background

Meaning of liabilities

11. At the settlement date of a contract for the supply of an enterprise, the vendor is responsible for paying liabilities that have been incurred prior to that date. However, in negotiating the supply of the enterprise, the vendor and purchaser may agree that the purchaser will assume the obligation to pay the vendor's existing and or future liabilities.

12. The word 'liability' is not defined in the GST Act. A liability is generally described as an 'obligation especially for payment; debt or pecuniary obligations; something disadvantageous'.[2] To be liable means to be 'subject, exposed, or open to something possible or likely' or to be 'under a legal obligation; responsible or answerable'.[3] For accounting purposes, a liability of a business is something owed by the business.

13. The following types of liabilities are commonly assumed by a purchaser:

- trade creditors/accounts payable;
- product warranties;
- long service leave obligations of employees;
- environmental rehabilitation;
- rates;
- land tax;
- plant and equipment or property leases; and
- hire purchase obligations.

14. For the purposes of this Ruling, and to determine the GST consequences, an 'assumption of a liability' by the purchaser of an enterprise focuses on the contractual arrangements entered into between the vendor and purchaser. It is the contractual arrangements and surrounding facts and circumstances that identify the transaction. This is the process by which the parties agree for a liability of the enterprise to be assumed by the purchaser. Therefore, it is not necessary to establish whether a liability of the vendor is in fact present and existing, contingent or uncertain at the time the enterprise is supplied. In either case, the focus is on what is agreed by the parties and the GST consequences that flow from this agreement.

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[2] The Macquarie Dictionary, Revised Third Edition, 2001.
[3] The Macquarie Dictionary, Revised Third Edition, 2001.

Assumption of liabilities

15. Liabilities may be imposed by and regulated by statute, or by contractual agreement.

16. In many cases where liabilities are imposed by statute, for example, the liability and calculation for employee long service leave entitlements, the statute has the effect of imposing the liability on the current owner of the enterprise. In these circumstances, the purchaser assumes the liability as a consequence of purchasing the enterprise. Upon transfer of the enterprise, the statute ceases to impose the liability on the former owner (vendor) and has the effect of imposing a liability on the new owner (purchaser). This is the effect of the statute and not the agreement between the vendor and the purchaser that results in the liability becoming that of the purchaser.

17. Liabilities imposed by statute are to be contrasted to liabilities the purchaser agrees, by the terms of the contract for the supply of the enterprise, to assume from the vendor. For example, a purchaser may agree to assume a contractual liability of the vendor, such as the balance owing to a trade creditor. Similarly, the purchaser may agree to assume a statutory liability of the vendor, where the effect of the statute is that the legal liability remains with the vendor. An example of the latter is unpaid rates for a rating period ending prior to the period when settlement occurs. In these cases, it is the agreement of the vendor and purchaser that causes the liability to be assumed by the purchaser.

18. The process of assuming a liability by contractual agreement was discussed by Gummow J in the context of a sale of a business in *TNT Skypak International (Aust) Pty Ltd v. FCT.*[4] He said:

> The liabilities could not be assumed in a legal sense by the taxpayer without novations with the creditors involved. For this the agreement did not provide. Rather, the assets of the business … were to be purchased and there was to be, as between the taxpayer and [the vendor], an assumption of liabilities, that is a promise by the [purchaser] to [the vendor] to pay the creditors of [the vendor], together with an indemnity of [the vendor] by the [purchaser] against claims by the creditors of [the vendor]. Thus, from a practical point of view, it may be said that the taxpayer 'assumed' the liabilities of [the vendor].

[4] 1988 ATC 4279 at 4287; 19 ATR 1067 at 1077.

19. In view of the above, an agreement between a vendor and purchaser for the transfer of a liability to the purchaser, without the consent of the creditor, has the *practical effect* of assigning the obligation. Although not legally released from the obligation, the vendor is *effectively released* because of the contractual promise by the purchaser to the vendor to pay the liability, and the indemnity provided in conjunction with the promise. For the purposes of this Ruling, we refer to this type of assumption as an 'effective assumption'.

20. An effective assumption is to be distinguished from a novation where the liability is legally assigned. 'Novation' can be described as a tripartite agreement whereby a contract between two parties is rescinded in consideration for a new contract being entered into on the same terms by one of the parties and a third party. It is a method of releasing one party from the contract and introducing another in its place.[5]

Consideration for the enterprise

21. Under an agreement for the sale of an enterprise, where a purchaser agrees to assume an existing liability of the vendor or where the purchaser becomes subject to a statutory liability after settlement, the vendor may:

- allow a 'set-off' (or reduction) to the agreed purchase price; or
- pay an amount to the purchaser representing the liability.

22. For example, where a business is sold for an agreed price of $100,000 and, as part of the agreement, the purchaser assumes the obligation to pay an outstanding vendor liability of the vendor, such as the balance owing to a trade creditor, the contract may allow a 'set-off' or reduction to the purchase price. For example, at settlement the purchaser pays $90,000 to the vendor, with an amount of $10,000 to be paid to a trade creditor.

23. Alternatively, the vendor may make a payment to the purchaser for the amount of the assumed liability. Using the above example, the vendor pays $10,000 to the purchaser at settlement, instead of allowing a 'set-off' in the contract. The purchaser pays $100,000 to the vendor so that, effectively, the vendor receives $90,000 ($100,000 less $10,000 paid to the purchaser) from the purchaser.

[5] Osborn's Concise Law Dictionary and Butterworths' Concise Australian Legal Dictionary.

Ruling

Statutory liabilities imposed on the purchaser

24. A purchaser of an enterprise does not make a supply within the meaning of section 9-10, or specifically within the meaning of paragraph 9-10(2)(g), an entry into an obligation, where the liability upon the purchaser is imposed, required and effected by the words of a statute.

25. This is also the case where the statutory liability is merely confirmed by way of contractual agreement between the parties.

26. The consideration for the supply of the enterprise by the vendor does not include the value of a liability which will be imposed upon the purchaser by statute after settlement. Any set-off allowed at settlement, or any payment from the vendor to the purchaser in respect of a statutory liability imposed on the purchaser, is a reduction to the price of the enterprise.

Quantified liabilities assumed by the purchaser

27. A purchaser assumes a liability of the vendor where, as part of the terms of the supply of the enterprise, the purchaser promises to the vendor that it will discharge, either immediately or in the future, the vendor's liability to a third party. The liability must be an amount quantified with certainty at the time it is assumed. Where the amount is not known with certainty, the vendor and purchaser must agree to a value representing the amount the purchaser will pay to discharge the vendor's liability.

28. In the circumstances above, a purchaser of an enterprise does not make a supply within the meaning of section 9-10.

29. The purchaser's assumption of the liability forms part of the consideration for the supply of the enterprise, expressed as money, paid by the purchaser for the enterprise.

Assignments of agreements

30. Where the vendor's interest in an ongoing contractual agreement is effectively assigned to the purchaser as part of the supply of an enterprise, the purchaser, by assuming the future contractual liability, does not make a supply within the meaning of section 9-10.

31. In these circumstances, the liabilities assumed require the purchaser to pay to a third party an amount in respect of the third party's performance of the contract after assignment and settlement. The liabilities assumed by the purchaser do not form part of the consideration for the supply of the enterprise. The payments are for the creditor's performance of its obligations under the assigned agreement, the benefit of which has been assigned to the purchaser.

32. To the extent that the purchaser agrees to pay the vendor's outstanding amounts prior to assignment, the effective assumption of this liability forms part of the consideration for the supply of the enterprise.

Indemnities in respect of liabilities assumed

33. Where a purchaser agrees to indemnify the vendor against any claims by the third party in respect of a liability assumed by the purchaser, the provision of the indemnity is incidental and ancillary to the purchaser's assumption of the liability. The indemnity is not a separate supply by the purchaser.

Does the purchaser make a taxable supply when it offers employment to the vendor's employees?

34. As part of the agreement for the acquisition of an enterprise, the purchaser may agree with the vendor to offer employment to some or all of the vendor's employees. The agreement may also provide for the vendor to pay the purchaser an amount representing the accrued leave entitlements of employees that accept the purchaser's offer of employment. The effect of this arrangement is that the obligations do not amount to the purchaser making a supply for consideration, within the meaning of paragraph 9-5(a).

GST-free supply of a going concern

35. The above principles apply equally whether or not the vendor and purchaser use the going concern exemption in section 38-325.

Explanation (this forms part of the ruling)

Does the purchaser of an enterprise make a 'supply' where liabilities are assumed?

'Supply'

36. The first requirement for a taxable supply under paragraph 9-5(a) is that 'you make a supply for consideration'. In order to determine whether an entity makes a supply within the meaning of the GST Act, it is necessary to examine more closely the meaning of 'supply'.

37. The word 'supply' is defined in subsection 9-10(1) as 'any form of supply whatsoever'. In a previous Ruling we have taken 'supply' to mean 'to furnish or provide'.[6]

38. Subsection 9-10(2), without limiting subsection 9-10(1), provides that 'supply' includes any of these:

(a) a supply of goods;

(b) a supply of services;

(c) a provision of advice or information;

(d) a grant, assignment or surrender of real property;

(e) a creation, grant, transfer, assignment or surrender of any right;

(f) a financial supply;

(g) an entry into, or release from, an obligation to do anything, to refrain from an act, or to tolerate an act or situation; and

(h) any combination of any 2 or more of the matters referred to above.[7]

39. In adopting the ordinary and natural meaning of the term,' to furnish or provide', it follows that an entity must take some action to 'make a supply'. This notion is consistent with the use of active phrases throughout the examples of supplies in section 9-10, such as the normalised verbs: 'a provision', 'a grant', 'a creation', 'a transfer', 'an entry into', and 'an assignment'.

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[6] Paragraph 16 of GSTR 2000/11: Goods and services tax: grants of financial assistance.

[7] However, under subsection 9-10(4), a supply does not include a supply of money, unless the money is provided as consideration for a supply that is a supply of money. 'Money' is defined in section 195-1.

'Make a supply'

40. The use of the word 'make' in the GST Act was considered by Underwood J in *Shaw v. Director of Housing and State of Tasmania (No 2)*[8] in relation to the payment of a judgment debt. His Honour was of the view that GST only applies where the 'supplier' makes a voluntary supply and not where a supply occurs without any action of the 'supplier'. Underwood J was considering the actions of the judgment creditor with respect to the extinguishment of the debt when the judgment debtor paid the judgment debt.

41. His Honour decided that there was no taxable supply by the judgment creditor, as the judgment creditor did not do any act or thing to extinguish the obligation when the judgment debtor paid the judgment debt.[9] At paragraph 19, Underwood J states:

> It is true that in some circumstances, a release occurs by operation of law. For example, the discharge of a bankrupt operates as a release from all his debts subject to certain exceptions. However, the GST Act, s9-5 opens with the words, 'You make a taxable supply if …' The verb 'make' indicates a legislative intention to impose the tax only on voluntary supplies, not upon those supplies that occur without an act of the releasor.

42. However, His Honour was of the view that an entity can still make a supply even if the supply is made under compulsion of statute. If an entity takes some action to cause a supply to occur, the entity makes a supply. In an example discussed by Underwood J, a liquidator would still make a supply of land, despite being obliged by statute to sell it.

43. To establish whether a purchaser makes a supply requires an examination and analysis of the transaction. It is necessary to examine whether the purchaser takes some action to 'furnish or provide' something under the agreement.

Does the purchaser make a supply where statutory obligations, for example, employee entitlements or environmental rehabilitation obligations, are imposed on the purchaser?

44. A vendor may, at the time immediately before settlement, be subject to a statutory liability associated with carrying on the enterprise. The statutory obligation may be a liability for the payment of money (such as long service leave entitlements to employees) or to do some other thing (such as environmental rehabilitation work). After settlement, the statute may operate to impose the liability on the

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[8] *Shaw v. Director of Housing and State of Tasmania (No. 2)* (2001) ATC 4054; (2001) 46 ATR 213; [2001] TASSC 2.

[9] This view is also endorsed by Hunter J in *Walter Construction Group Ltd v. Walker Corporation Ltd* (2001) 47 ATR 48; [2001] NSWSC 283.

purchaser because the liability rests with whoever is the employer or whoever is the owner of land, and the purchaser becomes the employer of employees, or the owner of an enterprise, the assets of which includes land, to which the purchaser receives title. As a result of the statute, after settlement, the vendor is no longer liable in relation to the matter covered by the statute.

45. For example, a statute may impose environmental obligations on the operator of a mining enterprise to rehabilitate land where mining activities have been carried out. A consequence of a sale of the mining enterprise is that the purchaser becomes the holder of the mining tenement and subject to the statutory liability as the holder of the mining tenement and the vendor is no longer primarily responsible under the statute.

46. Similarly, where there is a sale of an enterprise, the effect of various Commonwealth, State or Territory industrial relations statutes is to impose an obligation on the purchaser to pay the long service leave entitlements of ongoing employees. A common feature of the statutes is that they require the current employer to pay the entitlements calculated on the basis that the employee's period of service is deemed not to be broken by the change of employer as a result of the sale.

47. The particular statute and not the contract between the purchaser and the vendor imposes, requires and effects the obligation on the purchaser after settlement. This is the case even where the contract merely acknowledges the statutory liability and provides for an adjustment to the contract price to reflect that the purchaser undertakes to pay the liability. These contractual clauses merely confirm the operation of the statute.

48. It can be argued that the purchaser, by purchasing an enterprise that attracts a statutory liability, enters into an obligation within the definition of 'supply' in section 9-10. If this were the case, it would follow that the purchaser makes a supply.

49. However, for there to be a supply, an entity must take some action to cause the supply to occur. In the case of a purchaser of an enterprise who becomes an employer of the enterprise's continuing employees, the purchaser does not actively enter into an obligation to provide long service leave entitlements to the continuing employees in respect of their accumulated period of service with the previous employer (vendor). This obligation is imposed by statute, irrespective of any action taken by the purchaser.

50. Similarly, the purchaser of a mining enterprise does not actively enter into any obligations with the vendor to rehabilitate land where those obligations attach to the current holder of the mining tenement.

51. In these cases, the purchaser does not enter into an obligation to do anything in relation to the employee entitlements or mining rehabilitation. The purchaser does not 'make a supply'. The statute imposes, requires and effects the entry into the obligation, imposing the obligation as a consequence of being the current employer or the current operator of a mining enterprise.

52. To establish whether or not a statutory liability is imposed on the purchaser after settlement requires, in each case, an examination of the words of the particular statute in question. If the effect of the particular statute is that the original entity that incurred the liability remains legally liable despite supplying the enterprise, then the purchaser does not have an obligation imposed, required and effected by statute.

53. If the effect of a particular statute is that the vendor remains legally liable after settlement, the purchaser can only effectively assume the obligation by contractual agreement with the vendor. This requires some action by the purchaser, such that it is necessary to consider whether the purchaser makes a supply. The following paragraphs consider the effective assumption of a liability by way of contractual agreement.

Does the purchaser make a supply where vendor's liabilities are assumed by contractual agreement, for example, trade creditors, enterprise overheads, arrears of rates and land taxes, outstanding rent and lease payments?

54. When a purchaser acquires an enterprise, assumes an existing liability of the vendor, agrees to pay the purchase price to the vendor and to pay the existing liability directly to the creditor in discharge of the vendor:

(a) the payment of the amount of the purchase price to the vendor at settlement is monetary consideration for the supply of the enterprise; and

(b) the payment to the creditor is part of the consideration for the supply of the enterprise.

55. In relation to the payment to the creditor, it may be argued that the purchaser enters into an obligation to pay, which is a supply within section 9-10(2)(g) of the meaning of supply. If this were the case, it would follow that the purchaser makes a supply.

56. However, for the entry into an obligation to be a separate supply, the obligation must have economic value and an independent identity which is separate from the underlying transaction.[10]

[10] Paragraphs 80 to 85 of GSTR 2001/6: GST: non-monetary consideration.

57. The true nature of the transaction will characterise whether the provision of some rights and obligations are conditions of the contract, or the provision of non-monetary consideration and a separate supply.

58. We consider that these obligations are essentially another way of describing the consideration, such that they have no separate existence.[11] The 'obligation to make a payment' does not exist separately from the 'payment that is to be made'.[12] The 'obligation' is not classified as 'non-monetary' consideration that is capable of being separately analysed as a supply for the purposes of section 9-10.[13] The obligation on the purchaser is to pay the purchase price.

59. The purchaser's entry into the obligation to pay the vendor the purchase price does not have an independent identity that is separate from the actual payment.[14] Similarly, the purchaser's entry into an obligation to pay an amount to a creditor at the direction of the vendor, whilst it has economic value, does not have an independent identity separate from the promise to pay the full purchase price. The purchaser simply pays the purchase price, partly to the vendor at settlement and partly to the creditor (at the vendor's direction).

60. Therefore, the purchaser does not make a supply when, as a term or condition of the contract for the acquisition of the enterprise, the purchaser agrees to assume any or all of the liabilities of the vendor.

Does the purchaser make a supply when providing an indemnity for the liabilities it assumes?

61. If a purchaser agrees to indemnify the vendor against claims by the creditor in respect of the liability assumed, it may be argued that the provision of an indemnity by the purchaser is within the meaning of supply.

62. However, in the context of the supply of an enterprise where liabilities are assumed, we consider that the purchaser's provision of an indemnity is incidental and ancillary to the promise to pay the liability to the third party. It has the same character as the actual payment to the third party.[15] It does not have a character of its own or an independent identity. The indemnity does not constitute an object in itself, and merely provides a means for the vendor to better enjoy

[11] Paragraph 85 of GSTR 2001/6.
[12] Paragraph 85 of GSTR 2001/6.
[13] Paragraphs 3 and 16 of GSTR 2001/6.
[14] Paragraphs 80 and 81 of GSTR 2001/6.
[15] For discussion on whether parts of a supply are integral, ancillary or incidental to the dominant part of the supply, such that the parts need not be unbundled or dissected, refer to GSTR 2001/8 Goods and Services Tax: apportioning the consideration for a supply that includes taxable and non-taxable parts.

the purchaser's promise to pay and the purchaser's actual payment to the creditors. That is, the indemnity supports the dominant thing provided by the purchaser, which is the payment of the purchase price – part of which is paid to the creditor.

Does the purchaser make a supply by offering employment to the vendor's employees in circumstances where the purchase price is adjusted for the accrued entitlements of continuing employees?

63. It could be argued that a reduction or set-off to the consideration for the supply of the enterprise in the above circumstances is consideration provided by the vendor for a supply by the purchaser of entering an obligation to offer employment to the vendor's employees. This obligation is not imposed by statute. Although the purchaser positively acts to effect the entry into the obligation as part of the contract, the purchaser is not considered to make a supply for consideration, as required for a taxable supply, in respect of this obligation.

64. A term in the agreement where a purchaser agrees to offer employment is considered to be simply a term or condition for the supply of the enterprise. It does not have any economic value and independent identity separate from the transaction.

65. Further, the reduction or set-off by the vendor in respect of the accrued leave entitlements of the transferring employees does not amount to consideration for a supply by the purchaser of entering into an obligation to offer employment. A payment must have a sufficient connection, or nexus to a supply to represent consideration provided for that supply.[16] There is an insufficient nexus between this payment by the vendor and the entry into the obligation, with the payment being made as a result of employees accepting the offers, not in relation to the purchaser agreeing to make the offers. The payment represents a reduction to the purchase price for the enterprise, equal to an amount of money the new employer will require to be set aside for complying with the statutory requirements in respect of long service leave entitlements.

What consideration is provided by the purchaser for the supply of an enterprise?

66. Consideration for a supply is defined in section 195-1 to mean 'any consideration, within the meaning given by section 9-15, in connection with the supply…'

[16] Paragraph 56 of GSTR 2001/6.

67. Subsection 9-15(1) provides that a payment, or any act or forbearance, is consideration for a supply if it is 'in connection with',[17] 'in response to or for the inducement of'[18] a supply. A payment must have a sufficient connection, or nexus to the supply to represent consideration provided for that supply.[19]

68. Consideration for a supply can be money or something other than money. This is recognised in section 9-75 which provides for the calculation of GST payable on a taxable supply by reference to the price for the supply, which is the sum of:

- the consideration for the supply as expressed as an amount of money ('monetary consideration'); and
- the GST inclusive market value of any consideration that is not expressed as money ('non-monetary consideration').

69. In determining whether acts, rights or obligations are non-monetary consideration, the thing must have economic value and an independent identity which is separate from the underlying transaction.[20]

Consideration – statutory liability imposed on the purchaser

70. Where the effect of a statute is to impose a liability on the purchaser as a consequence of acquiring a particular enterprise, the purchaser must pay the liability irrespective of any agreement entered into with the vendor. The statute requires the purchaser to pay the liability.

71. Given that the purchaser becomes legally liable after settlement, the consideration for the supply of the enterprise by the vendor does not include the value of a statutory liability imposed on the purchaser.

72. Any set-off allowed at settlement in respect of the statutory liability merely represents a reduction (or discount) to the purchase price for the supply of the enterprise. This discount reflects the fact that the enterprise is worth less to the purchaser, given that the purchaser will become subject to the statutory obligation. The set-off is simply the means by which the parties calculate the consideration that the purchaser must pay for the enterprise under the contract.

[17] Paragraph 9-15(1)(a).
[18] Paragraph 9-15(1)(b).
[19] Paragraph 56 of GSTR 2001/6.
[20] Paragraphs 80 to 81 of GSTR 2001/6.

73. Support for this view is found by analysing which of the entities is legally liable to the creditor. For example, for long service leave entitlements, the uniform effect of the various industrial relations statutes is to extinguish the liability of the vendor, and to impose a liability on the purchaser. It follows that, when the purchaser actually pays the entitlements to the employees, the purchaser does so in satisfaction of its own legal obligation. The payments discharge the purchaser's legal liability, not the vendor's. Since neither the actual payments nor the obligation to make the payments, are provided to the vendor, or at the vendor's direction for the discharge of the vendor's debt, the amount does not form part of the consideration for the supply of the enterprise by the vendor. There is not a sufficient nexus between the payment of the statutory liability and the supply of the enterprise by the vendor. This is in contrast to the effective assumption by the purchaser of, for example, a trade creditor debt where the effect of the payment by the purchaser is the discharge of the vendor's debt.

74. Support for this view is found in *Federal Commissioner of Taxation v. Foxwood (Tolga) Pty Ltd*[21] where the High Court considered whether a payment from a vendor to a purchaser in respect of accrued leave entitlements was deductible for income tax purposes. The court held the amount paid in respect of holiday pay to be a revenue outgoing, given that the vendor remained liable to the employees for this amount, whereas the amount paid in respect of long service leave was capital, given that the vendor was no longer to be liable to the employees for this outgoing. Wilson J, said in relation to the amount for long service leave:

> By virtue of the Act, the purchaser of the business became solely responsible for that liability. This being so, the payment necessarily assumes the character of an adjustment to the purchase price on the sale of the taxpayer's business.[22]

75. In addition, it was noted by Young J in the High Court of New Zealand in *Iona Farm Limited v. Commissioner of Inland Revenue*,[23] that a liability to pay rates imposed on a lessee is not part of the consideration for the supply under the lease. In that case, the effect of the statute was to impose rates on the lessee, since the lease was for greater than twelve months. His Honour distinguished this from the situation in *The Trustee, Executors and Agency Company New Zealand Limited & Ors v. Commissioner of Inland Revenue*,[24] where the primary liability for the rates was with the lessor, the lessee being obliged to pay only because of a term of the lease.

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[21] 81 ATC 4261; 11 ATR 859.
[22] 81 ATC at 4270; 11 ATR at 869.
[23] 19 NZTC 15,261.
[24] (1997) 18 NZTC 13,076. This case concerned whether the payment of rates by the tenant was consideration for the supply of premises under the lease of the property.

Consideration – liability effectively assumed

76. In relation to the effective assumption by the purchaser of a liability of the vendor, which consists of the payment of the vendor's liability to a third party, the question arises as to whether this amount forms part of the consideration for the purchase of the enterprise. That is, does the purchase price of the enterprise include the payment to a third party?

77. The Commissioner has stated in Goods and Services Tax Determination GSTD 2000/10[25] that, where a single supply of real property under a commercial property lease is made, the reimbursement or direct payment (to third parties) of the landlord's obligations is consideration for the supply of the premises.

78. Support for this view is found in the decision of Chisholm J in the New Zealand case *of The Trustee, Executors and Agency Company New Zealand Limited & Ors v. Commissioner of Inland Revenue.* He stated that a payment made directly to a third party does not disqualify the payment from satisfying a sufficient nexus to a supply by a vendor. He stated at 13,086:

> But in my opinion the crucial factor is the strength of the connection between the payment and the supply. If there is sufficient proximity between the supply and payment to satisfy the requirement that the payment is 'in respect of' (or 'in response to, or for the inducement of') the supply of goods then the payment qualifies as 'consideration' notwithstanding that the payment is made to a third party.

79. In that case, Chisholm J considered whether the payment of rates by a tenant in accordance with their lease agreement was consideration for a supply by the local rating authority, or whether it was merely additional consideration for the supply of the leased premises by the landlord. He found that the landlord was primarily liable for the rates and that the payment by the tenant to meet that liability is properly regarded as part of the consideration for the supply of the premises.

[25] GSTD 2000/10: are outgoings payable by a tenant under a commercial property lease part of the consideration for the supply of the premises?

80. Further, the Privy Council in *Commissioner of Inland Revenue v. New Zealand Forest Research Institute Ltd*[26] held that an amount to represent the assumed liabilities of a vendor formed a part of the purchase price despite the fact that the payments when made were paid directly to a third party. The Privy Council stated at 15,692 that:

> It seems to their Lordships plain that, viewed in this light, the payments [to the third parties] were capital expenditure, being part of what was paid for the acquisition of the assets. There can be no doubt that the discharge of the vendor's liability to a third party, whether vested or contingent can be part of the purchase price. It does not matter that the payment is not made at once but pursuant to an arrangement whereby the purchaser agrees to be substituted as debtor to the third party.

81. The amount that the purchaser agrees to pay to a third party is monetary consideration that forms part of the consideration for the supply of the enterprise. It is part of the purchase price that is paid at the direction of the vendor to a third party.

82. By way of contrast, the provision of an indemnity by the purchaser to the vendor in respect of claims by creditors is integral and ancillary, or incidental to the provision of the monetary consideration. The indemnity has no additional independent value to the payment of the monetary consideration to the third parties.

83. Where a contract expresses an amount for the purchase price and allows a set-off to the purchase price at settlement in respect of the amount of a quantified liability of the vendor that has been assumed, the liability assumed forms part of the total consideration for the supply of the enterprise.

84. For example, a contract may express the purchase price as $100,000, with a set-off allowed at settlement for a creditor liability assumed of $10,000. The liability is to be paid directly to the creditor. In this case, the consideration for the supply of the enterprise is the agreed purchase price of $100,000. $90,000 is paid at settlement and $10,000 is paid to the creditor. If the vendor's supply of the enterprise is a taxable supply and a tax invoice is issued, the tax invoice will reflect the total purchase price of $100,000.

85. If a contract expresses the purchase price exclusive of the amount of liabilities assumed, where there is no 'set-off' in respect of the liabilities assumed, the consideration for the enterprise is:

- the purchase price paid to the vendor at settlement; plus
- the amount of the liability effectively assumed.

[26] (2000) 19 NZTC 15,689. This was an income tax case dealing with the capital cost of acquiring a business.

86. For example, a contract may express the purchase price as $90,000, the parties having already taken into account the liabilities in negotiating the price. In addition to the purchaser's obligation to pay the purchase price, the contract also includes a clause for the effective assumption of a liability of $10,000 for overdue lease payments. The consideration for the supply of the enterprise is $100,000, being the sum of the purchase money paid at settlement, and the amount to be paid to the creditor. If the vendor's supply of the enterprise is a taxable supply and a tax invoice is issued, the tax invoice will reflect the total purchase price of $100,000.

Consideration – ongoing contract assigned to purchaser

87. In the context of a supply of an enterprise, the vendor may assign to the purchaser its interest under an ongoing contract for supplies by a third party, for example, a plant and equipment lease. In these circumstances, the purchaser agrees to:

- pay the purchase price;
- assume the future obligations under the assigned agreement; and
- indemnify the vendor against any claims by the third party in respect of the obligations that accrue under the agreement after settlement.

88. The future amounts to be paid to the third party under the assigned agreement do not form part of the consideration for the supply by the vendor. The payments are for the third party's ongoing performance of the contract in favour of the purchaser. That is, the payments are for the supply by the third party. The ongoing payments do not have a sufficient nexus with the supply of the enterprise by the vendor.

89. The purchaser assumes the obligations under the assigned agreement as a condition of the supply of the enterprise and the assignment. The purchaser receives the interest in the agreements as part of the things that make up the enterprise, the obligations under the agreement attaching to the interest which is supplied to the purchaser. That is, the thing supplied to the purchaser is the interest under the agreement, which includes the obligations. The assignment is not dissected into a supply by the vendor of the benefits of the agreement, and a supply by the purchaser of an entry into an obligation regarding the burdens of the agreement. The assignment is of a single thing, being the whole of the vendor's interest under the agreement.

90. Where an agreement is assigned to the purchaser of enterprise assets, under normal commercial practice the vendor would be indemnified by the purchaser against any claims by the third party arising after the assignment. Similarly, the vendor would indemnify the purchaser against any claims arising under the agreement in respect of the period before the assignment. We consider that these indemnities are merely terms and conditions of the assignment, and are not separate supplies or separate amounts of non-monetary consideration.

Examples

Example 1 – Purchaser of an enterprise assumes long service leave liabilities

91. Vendor enters an agreement to sell its enterprise to Purchaser for an agreed price of $100,000. Under the agreement, Purchaser agrees to retain all of Vendor's employees and to honour their accrued leave entitlements. For the purpose of calculating an employee's long service leave entitlements, the relevant state or territory statute deems the employee's period of service to be unbroken when an enterprise is sold. The statute also requires the current employer to pay the entitlements when the employee is eligible, having regard to their deemed 'unbroken' length of service.

92. Vendor agrees to allow a settlement adjustment in favour of Purchaser calculated by an agreed formula representing the value of accrued employee entitlements as at the settlement date. The amount allowed in the contract for employee entitlements is $8,000. Purchaser pays $92,000 to Vendor at settlement.

93. Under the transaction, Purchaser does not make a supply of entering into an obligation to pay the employees their full entitlements. This obligation is imposed on Purchaser by statute. Any contractual term that provides that Purchaser is liable for payment of employee entitlements merely confirms the obligation imposed by statute.

94. Purchaser does not make a supply by agreeing to offer employment to Vendor's employees, and the $8,000 allowed at settlement is not consideration for a supply by Purchaser.

95. The consideration for the supply of the enterprise is $92,000, being the adjusted purchase price. The $8,000 which Vendor allows Purchaser under the terms of the contract is a reduction in consideration for the enterprise. The reduction recognises that a statutory liability attaches to the supply of this particular enterprise.

Example 2 – Purchaser of an enterprise pays rates levied on business premises in respect of period during which settlement occurs

96. Purchaser acquires assets making up an enterprise, including the freehold interest in commercial premises. The agreed price under the contract is $500,000, with an adjustment to be made in respect of rates to be levied on the property.

97. The effect of the particular rating statute is that the owner of the land for the time being is liable for rates, which are assessed in arrears at the end of each quarter. The contract provides for an adjustment in respect of Vendor's share of rates that will be assessed on Purchaser after settlement. An estimation of the rates for the period is apportioned by the number of days during the period in which Vendor is in possession of the land. The adjustment results in Purchaser being allowed $500 at settlement, given that Purchaser will be liable for the full amount at the end of the rating period.

98. The consideration for the supply of the enterprise is $499,500, being the adjusted purchase price. The rates, in accordance with the relevant statute, attach to the land. The $500 adjustment is a reduction of the amount that Purchaser is liable to pay Vendor for the transfer of the enterprise assets, including the land. As the liability for rates is imposed primarily upon Purchaser, payment of the rates does not discharge a liability of Vendor (as once title passes, Vendor is not liable for the rates) and is not a payment at Vendor's direction.

Example 3 – Purchaser of an enterprise pays rates levied on business premises in respect of period before settlement

99. As in Example 2, Vendor enters an agreement to sell its enterprise to Purchaser for an agreed price of $500,000. One of the enterprise assets sold as part of the agreement is the freehold interest in commercial premises.

100. Local statutes impose rates on the commercial premises upon the owner of the land.[27] At settlement date, Vendor has not paid an amount of rates levied prior to settlement of $1,000. The effect of the particular statute is that Vendor is liable for the total amount, as the period in respect of which the rates were levied ended prior to settlement, such that Vendor was the owner for the entire period.

101. In the agreement for the supply of the enterprise, Purchaser agrees to pay $1,000 overdue rates of Vendor. Vendor agrees to a set-off of $1,000 against the purchase price of the enterprise assets.

[27] It is necessary to examine individual statutes in the various jurisdictions to establish the effect of the particular statute, particularly where there is a change of ownership.

102. At settlement Purchaser pays Vendor $499,000. Purchaser does not make a supply by promising to pay Vendor's rates. This is because the promise to pay the rates is part of the consideration for the supply of the enterprise, being an amount paid to the rating authority at the direction of Vendor to discharge Vendor's liability. The consideration for the supply of the enterprise is $500,000.

Example 4 – Purchaser of an enterprise assumes trade creditor liability – 'set-off' of liability

103. Vendor enters an agreement to sell its enterprise to Purchaser for an agreed price of $100,000. Under the agreement, Purchaser agrees to pay all trade creditor liabilities that exist at settlement and provides an indemnity in respect of any claims by the trade creditors. Vendor agrees to allow a set-off to the purchase price in favour of Purchaser equal to the amount of the trade creditor liabilities assumed.

104. The trade creditors outstanding at settlement are owed $10,000. The trade creditors are not aware of the agreement between Vendor and Purchaser. In accordance with the 'set-off' provisions in the contract, Purchaser pays $90,000 to Vendor at settlement.

105. The consideration for the supply of the enterprise is $100,000, being $90,000 paid to Vendor and $10,000 to be paid, at Vendor's direction, to the creditors. Under the transaction Purchaser does not make a supply, and everything that Purchaser provides is consideration expressed as an amount of money.

106. This result is the same regardless of whether or not the supply of the enterprise is a GST-free supply of a going concern.

Example 5 – Purchaser of an enterprise assumes trade creditor liability – assumption of liability

107. As in Example 4, Vendor agrees to sell its enterprise to Purchaser and Purchaser agrees to assume a particular trade creditor liability. Purchaser and Vendor, knowing the liability outstanding to be $10,000, negotiate the purchase price to be $90,000.

108. Purchaser pays $90,000 to Vendor at settlement and, pursuant to the terms of the contract, assumes the trade creditor liability of $10,000. The consideration for the supply of the enterprise is $100,000, even though the contract expresses the purchase price as $90,000. That is, the consideration is made up of the $90,000 as well as the additional $10,000 the parties have agreed will be paid to the trade creditors. The assumption of the liability forms part of the

consideration for the business and is consideration expressed in money.

Example 6 – Purchaser of enterprise assumes product warranty liabilities

109. Vendor is a manufacturer of widgets. All widgets are sold with a 3 year warranty. Vendor enters into an agreement to sell its enterprise to Purchaser for an agreed price of $100,000. Under the agreement, Purchaser agrees to honour all warranty obligations to Vendor's customers in respect of defective products sold by Vendor prior to selling the enterprise.

110. Vendor agrees to allow a settlement adjustment in favour of the purchaser calculated by a statistical estimation of the value of warranty claims likely to be made, based on previous history of claims and volume of sales. The agreed formula calculates the warranty liability at $4,000, as at settlement date. The customers are not aware of the sale of the enterprise.

111. Purchaser pays $96,000 at settlement. Purchaser does not make a supply, by agreeing to pay for warranty claims. However, Purchaser's agreement to honour warranty claims valued at $4,000 to the customers (creditors of Vendor) forms part of the consideration for the enterprise expressed as money. The consideration for the enterprise is $100,000.

Example 7 – Vendor of enterprise assigns lease agreement to purchaser

112. Vendor enters an agreement to sell its enterprise to Purchaser for an agreed price of $100,000. Vendor leases premises from Landlord for $1,000 per month.

113. At the date of settlement, exactly 12 months remain on the lease. All monthly lease payments are paid by Vendor up to the date of settlement.

114. Vendor assigns the benefits of the lease of the premises to Purchaser as part of the supply of the enterprise. Purchaser agrees with Vendor to pay the lease payments that fall due in respect of the period after settlement, and to indemnify Vendor against any claims by Landlord in respect of the lease payments.

115. Purchaser does not make a supply in respect of assuming the future lease obligations because the entry into the obligation does not have an independent identity separate from the transaction or an economic value and is merely a condition upon which the lease is assigned.

116. The consideration for the supply of the business does not include the future lease payments to be made by Purchaser to the Landlord. These payments have a nexus with the supply of premises made by the Landlord under the lease, the benefit of which has been assigned to Purchaser.

Your comments

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

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Commissioner of Taxation
26 May 2004

Previous draft:

Not previously released in draft form

Related Rulings/Determinations:

GSTD 2000/10; GSTR 1999/1; GSTR 2000/11; GSTR 2001/6; GSTR 2001/8; GSTR 2002/5

Subject references:

- assumption of liabilities
- consideration
- debt
- liabilities
- monetary consideration
- non-monetary consideration
- supply

Legislative references:

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- Commissioner of Inland Revenue v. New Zealand Forest Research Institute Ltd (2000) 19 NZTC 15,689
- Federal Commissioner of Taxation v. Foxwood (Tolga) Pty Ltd 81 ATC 4261; 11 ATR 859
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