Taking the purpose out of creditable purpose

GST

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Abstract: For almost 16 years, since GST was introduced, practitioners have made endeavours to complete the puzzle on the meaning of "creditable purpose". The definition of this foundational concept has been judicially considered in landmark cases such as *HP Mercantile and Rio Tinto* – both decisions attempting to shed light on s 11-15 of the *A New Tax System (Goods and Services Tax) Act 1999*, a unique provision with no real analogue in the GST/VAT world. This article explores the *Rio Tinto* decisions in the context of previous judicial decisions; proposes that determining creditable purpose involves a two-step process; and seeks to illustrate the relevant principles through a common and practical example. The author notes that *Rio Tinto* is unlikely to be the last judicial foray into the statutory construct of creditable purpose, especially as the case involved an enquiry into the relationship between an input and an intermediate output, though the decision enables practitioners to place a few more pieces into the GST puzzle.

> "One might perhaps have hoped for a more apt expression than 'creditable purpose' to refer to the simple notion of an acquisition in the course of the carrying on of an enterprise."[1]

Overview

Goods and services tax (GST) practitioners have been endeavouring to complete the GST jigsaw puzzle for almost 16 years now. Foundational concepts, such as "supply" and "consideration", have been judicially considered with their meanings slowly elicited. Another foundational concept, "creditable purpose" has been judicially considered several times, and on each occasion, more pieces are added to the puzzle. The latest decisions in *Rio Tinto* continue this journey.[2]

This article explores the *Rio Tinto* decisions in the context of previous judicial decisions on creditable purpose; proposes some additional considerations; and seeks to illustrate the relevant principles through a common and practical example. The author concludes that *Rio Tinto* is unlikely to be the last judicial foray into this foundational concept.

Legislation

All legislative references in this article are to the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA), unless otherwise stated.

Section 7-1(2) provides that entitlements to input tax credits arise on "creditable acquisitions" and "creditable importations". This article will focus on creditable acquisitions only. The requirements for creditable acquisitions are set out in s 11-5, which provides that:

> "You make a ***creditable acquisition*** if:
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> (a) you acquire anything solely or partly for a creditable purpose; and
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> (b) the supply of the thing to you is a taxable supply; and
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> (c) you provide, or are liable to provide, consideration for the supply; and
>
> (d) you are registered, or required to be registered."

The meaning of "creditable purpose" is set out in s 11-15, which relevantly states that:

> "(1) You acquire a thing for a ***creditable purpose*** to the extent that you acquire it in carrying on your enterprise.
>
> (2) However, you do not acquire the thing for a creditable purpose to the extent that:
>
> (a) the acquisition relates to making supplies that would be *input taxed; or
>
> (b) the acquisition is of a private or domestic nature."

"Input taxed" supplies are set out in Div 40, and s 40-35(1)(a) relevantly provides that a supply of residential premises that is by way of lease is an input taxed supply.

Section 11-25 provides that the amount of the input tax credit for a creditable acquisition is an amount equal to the GST payable on the supply of the thing acquired. However, the amount of the input tax credit is reduced if the acquisition is only "partly creditable". A "partly creditable" acquisition is defined in s 11-30(1) as follows:

> "(1) An acquisition that you make is ***partly creditable*** if it is a *creditable acquisition to which one or both of the following apply:
>
> (a) you make the acquisition only partly for a *creditable purpose;
>
> (b) you provide, or are liable to provide, only part of the *consideration for the acquisition."

The amount of the input tax credit on a partly creditable acquisition is determined using the formula in s 11-30(3):

> "Full input tax credit × Extent of creditable purpose × Extent of consideration
>
> where:
>
> ***extent of consideration*** is the extent to which you provide, or are liable to provide, the consideration for the acquisition, expressed as a percentage of the total consideration for the acquisition.
>
> ***extent of creditable purpose*** is the extent to which the creditable acquisition is for a creditable purpose, expressed as a percentage of the total purpose of the acquisition.
>
> ***full input tax credit*** is what would have been the amount of the input tax credit for the acquisition if it had been made solely for a creditable purpose and you had provided, or had been liable to provide, all of the consideration for the acquisition."

Subsequent adjustments may arise if there are changes in the extent of creditable purpose (Div 129); if goods are applied solely to private or domestic use (Div 130); or if acquisitions are made without full input tax credits and then applied for a non-creditable purpose (Div 132).

The Rio Tinto decisions

The *Rio Tinto* decisions deal with input tax credits for acquisitions that had a connection with residential accommodation provided to employees in remote areas. The key issue in these cases was whether the acquisitions were made wholly or partly for a creditable purpose.

The Commissioner accepted that the acquisitions had been made in the course of carrying on an enterprise and therefore the application of s 11-15(1) was not at issue in the proceedings.

Facts

Rio Tinto Services Ltd (Rio Tinto) was at all relevant times the representative member of a GST group which included Hamersley Iron Pty Ltd (Hamersley) and Pilbara Iron Company (Services) Pty Ltd (Pilbara).

Rio Tinto claimed that it was entitled to input tax credits for acquisitions made by Hamersley and Pilbara in providing, and maintaining, residential accommodation for Hamersley's workforce in the remote Pilbara region in Western Australia. Hamersley was in the business of mining and selling iron ore. Under an agreement with the state of Western Australia, Hamersley was required to establish townships in the region to provide residential accommodation and associated infrastructure for the workforce in the Pilbara operations. Hamersley owned about 2,295 houses and apartments in the Pilbara region which were leased to employees and contractors either working in the mining operations or in the service industries supporting the townships.

In order to attract and retain workers in the Pilbara region, Hamersley substantially subsidised the rent for the accommodation. Without this subsidy, the cost of accommodation would not have been economically viable for most workers. Hamersley therefore incurred substantial losses in respect of the accommodation, although it made substantial profits for the associated iron ore production business. In the year ended 31 December 2010, the relevant revenue, expenses and profit for Hamersley's operations in the Pilbara region are set out in Table 1.

Table 1

Item	Revenue	Operating expenditure	Profit before tax
Iron ore production	$4,987,709,513	($1,613,743,534)	$3,373,965,979
Accommodation	$6,148,841	($38,881,117)	($32,732,276)
Total	$4,993,858,354	($1,652,624,651)	$3,341,233,703
Iron ore as percentage of total	99.88%	97.65%	100.98%

The relevant categories of expenses that were at issue in this case were:

- construction and purchase of new housing;
- refurbishment, minor works, maintenance and repairs of the housing;
- mould removal, remediation and general hygiene cleansing; and
- cleaning, landscaping and pool maintenance.

The Federal Court decision

Rio Tinto's submissions

Rio Tinto's primary submission was that the relevant acquisitions were made wholly for a creditable purpose "because the supply of the residential accommodation was not an end commercial objective in itself but was wholly incidental to Hamersley's mining operations as a necessary and essential part of those operations".[3] Rio Tinto accepted that the provision of the accommodation was an input taxed supply and accepted that there was a connection between the acquisitions and the provision of that accommodation.[4] However, Rio Tinto argued that the relevant acquisitions did not "relate to" the making of input taxed supplies because the "moving cause" or "purpose" of the supply of residential accommodation was the carrying on of the taxable mining enterprise and that the leasing of accommodation was not "an end activity in itself".[5] That is, the supply of residential premises was "merely an intermediate step" and "a necessary input" in the carrying on of Hamersley's mining enterprise and that the accommodation "would not have been provided but for the fact that it is essential in its business".[6]

Rio Tinto's alternative submission was that partial input tax credits should be available on the basis that an apportionment was required "to the extent that" the acquisitions also related to making supplies of input taxed residential accommodation. Rio Tinto submitted that a fair and reasonable apportionment should be undertaken using a revenue-based method. That is, the amount of revenue derived from sales of iron ore from the Pilbara mining operations as a proportion of total revenue generated from those operations (including rental revenue). The use of this methodology would have resulted in an entitlement of 99.88% of the relevant input tax credits.[7]

The Commissioner's submission

The Commissioner's case was simply "that s 11-15(2)(a) applies because the acquisitions in question had a direct and immediate connection with the supply of residential accommodation by way of lease, being an input taxed supply".[8]

Reasoning of the Federal Court

Rio Tinto, in support of its submissions, suggested that the New Zealand case of *BNZ Investment Advisory Services Ltd*[9] was instructive.[10] In that case, BNZ provided taxable investment advice to clients in return for modest fees. However, if the client acted on that advice by making investments, BNZ would receive a much larger fee from the financial institution that sold the relevant investments. Such supplies are treated as exempt in New Zealand (that is, the equivalent of input taxed in Australia). BNZ argued that it should be entitled to claim full input tax credits in respect of its overhead costs on the basis that the principal purpose of making these acquisitions was to make supplies of taxable investment advice, rather than exempt sales of financial investments. The High Court rejected BNZ's argument and held that the "principal purpose" of the acquisitions was to derive income from its exempt services and that the giving of investment advice was merely a means to that end.

Davies J observed that whether the equivalent of input tax credits could be claimed in New Zealand depended on whether the acquisitions were made for the "principal purpose" of making services that were taxable supplies or exempt supplies.[11] Rio Tinto accepted that the statutory test in New Zealand is expressed in different language but submitted that

the scheme under the GSTA was not relevantly different.[12] Davies J rejected this submission and examined in turn the structure, text and policy of s 11-15. As to structure, the following passage of Hill J (with whom Stone and Allsop JJ agreed) in *HP Mercantile* was cited:[13]

> "It is, perhaps, not unremarkable that s 11-15 of the GST Act bears, in its structure, some similarity to the general business deduction provisions of the Australian income tax law, ie s 51(1) of the *Income Tax Assessment Act 1936* (Cth) and s 8-1 of the *Income Tax Assessment Act 1997* (Cth). In both the GST provision and the income tax provisions, there is a need to pass first through a positive test. In the case of GST, the positive test is the requirement that the acquisition has been in whole or in part acquired in carrying on an enterprise. In the income tax context, there is the need to find that the loss or outgoing be incurred in gaining or producing assessable income, or in carrying on a business. In both cases apportionment arises where the positive test is only partly satisfied. Next, both require consideration of negative tests which exclude the allowance of a credit in the GST context or the allowance of a deduction in the income tax context. In the GST context the negative tests are those set out in s 11-15(2) of acquisitions relating to supplies that would be input taxed or acquisitions of a private and domestic nature. In the income tax context, the negative tests also involve the case where the loss or outgoing is of a private and domestic nature as well as where it is capital or of a capital nature. In both cases, a question of apportionment arises where the negative tests only partly apply."

Davies J observed that, unlike the New Zealand legislation, s 11-15 does not use the language of, or require, or even direct, an enquiry into purpose; the expression "creditable purpose" is a statutory construct and has a specific statutory meaning.[14] Within the terms of s 11-15(1), a "creditable purpose" is attributed according to whether, and the extent to which, goods or services are acquired by an entity "in carrying on" its "enterprise". The word "in" simply means "in the course of" in the same way as that word has been construed in the context of s 8-1 of the *Income Tax Assessment Act 1997* (Cth).[15]

Goods or services are acquired by an entity for a "creditable purpose" if the acquisition is *connected* with the activities that constitute the entity's "enterprise". Whether an acquisition has such a connection will depend on the scope of the activities that constitute the entity's "enterprise". If the acquisitions relate to an enterprise carried on by the entity, the terms of s 11-15(1) are engaged. Section 11-15(2)(a) must be considered in context with s 11-15(1) and only falls to be considered if s 11-15(1) applies, that is, where an acquisition has the requisite connection with the entity's enterprise.[16]

As to textual considerations, Davies J pointed out that s 11-15(2)(a) is concerned with a different enquiry to s 11-15(1). The language of s 11-15(2)(a) directs an enquiry into whether the acquisition has a nexus with input taxed supplies that an entity makes in carrying on its enterprise. The use of the words "however" and "to the extent that", as they relate to s 11-15(2)(a), indicate that something may be acquired in carrying on an enterprise (that is, satisfy s 11-15(1)) but nonetheless wholly or partly "relate" to making supplies that would be input taxed.[17] The legislative scheme of the GSTA contemplates that an entity may make taxable supplies, GST-free supplies and input taxed supplies, all as part of the activities constituting an entity's "enterprise".[18] An apportionment is required to the extent that an acquisition has a relevant relationship with both the making of taxable supplies and input taxed supplies, such as where there are undifferentiated general overhead outgoings.[19]

> *"... the expression 'creditable purpose' is a statutory construct and has a specific statutory meaning."*

Davies J pointed out that the words "relates to" must be given a meaning that depends on the context in which they are used and that for s 11-15(2)(a) to apply, the relationship must be one that is "sufficient" or "material". The disentitling factor that disallows input tax credits which otherwise would be available is a relationship with the making of input taxed supplies on which no GST is payable.[20] In an important passage, Davies J states:[21]

> "The qualification that an entity does not have a creditable purpose 'to the extent' that an acquisition meets the requirements of s 11-15(1) but also falls within the terms of s 11-15(2)(a) thus gives meaning and content to the required relationship between the acquisition and input taxed supplies for the purposes of s 11-15(2)(a). If an entity makes input taxed supplies, and makes acquisitions that relevantly relate to the making of those input taxed supplies, s 11-15(2)(a) operates to deny input tax credits on those acquisitions. It is the objective relationship between an acquisition and making supplies that would be input taxed with which s 11-15(2)(a) is concerned, not the moving cause or principal purpose behind the acquisition. The purpose for which an acquisition was made may in some cases bear upon whether the acquisition has a relevant relationship with the making of supplies that would be input taxed, but it is the existence of a connection or relationship between the acquisition and supplies that would be input taxed that is the statutory criterion directed by s 11-15(2)(a)."

The last sentence may at first glance appear to cause difficulty. If the relationship between an acquisition and making supplies that would be input taxed must be objective, and if s 11-15 does not use the language of, or require, or even direct, an enquiry into purpose, how then can the "purpose for which an acquisition was made … bear upon whether the acquisition has a relevant relationship with the making of supplies that would be input taxed"? It is respectfully suggested that the difficulty is resolved once it is understood that the expression "purpose" is being used with a particular meaning which relates to objective, rather than subjective, purpose. This will be discussed in more detail below.

As to policy considerations, Rio Tinto referred to the enactment of s 40-35 (which input taxes residential accommodation) and the accompanying explanatory memorandum to the effect that the purpose of s 40-35 is to put renters in the same position as owner/occupiers.[22] Rio Tinto argued that s 40-35 is only concerned with a supply to an ultimate consumer, not to an intermediate supply as a step in the making of another supply that is the objective of the "enterprise". Davies J thought there were difficulties in following how that proposition flowed from the apparent legislative object of s 40-35, as it was uncontroversial that input taxed supplies of residential accommodation were made. The real issue was whether a requisite relationship existed between

the acquisitions which were the subject of the dispute and the making of those input taxed supplies.[23]

Rio Tinto also referred to the legislative policy articulated by Hill J in *HP Mercantile* in the following well-known passages:[24]

> "The gen[i]us of a system of value added taxation, of which the GST is an example, is that while tax is generally payable at each stage of commercial dealings (supplies) with goods, services or other 'things', there is allowed to an entity which acquires those goods, services or other things as a result of a taxable supply made to it, a credit for the tax borne by that entity by reference to the output tax payable as a result of the taxable supply. That credit, known as an input tax credit, will be available, generally speaking, so long as the acquirer and the supply to it (assuming it was a taxable supply) satisfied certain conditions, the most important of which, for present purposes, is that the acquirer make the acquisition in the course of carrying on an enterprise and thus, not as a consumer. The system of input tax credits thus ensures that while GST is a multi-stage tax, there will ordinarily be no cascading of tax. It ensures also that the tax will be payable, by each supplier in a chain, only upon the value added by that supplier.
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> …
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> The language of the GST Act, as seen in the context of value added taxation generally, makes it clear that the legislative scheme is that a taxpayer will be entitled to an input tax credit where it is necessary that a credit be given to ensure that output tax payable by the taxpayer is not imposed upon an amount which already includes tax payable at some early stage in the commercial cycle. Where possible, GST is not to be found embedded in the price or consideration on which output tax is calculated when taxable supplies are made. However, in the case of a taxpayer which makes input taxed supplies, while that taxpayer will not be liable to output tax on the supplies it makes which satisfy the description of input taxed supplies, that taxpayer will be denied an input tax credit for the tax payable on acquisitions it makes where the necessary relationship exists."

Rio Tinto argued that this policy would be defeated since the Commissioner's construction of s 11-15 meant that Hamersley could only recoup the GST cost in the price of its taxable activities (thereby resulting in cascading of tax) or in the price of its exports (thereby resulting in GST being borne on exports) because its residential leasing activities operated at a loss.[25]

Davies J offered a number of responses to this submission.

First, the task of statutory construction does not seek to identify or assume the underlying policy of a provision and then to construe that policy. The observations of Hill J in *HP Mercantile* could be accepted but those observations do not provide the answer to the proper construction of s 11-15.[26] Second, the fact that it may have been necessary to subsidise the rent on the accommodation in order to attract and retain its workforce, with the consequence that the leasing activity was loss making, did not gainsay the application of s 11-15(2)(a).[27] Third, it is the transaction that determines the GST outcome. Rio Tinto chose to lease accommodation to its workforce with the consequence that s 40-35 applied and the provision of accommodation was an input taxed supply. The policy to deny input tax credits where the acquisitions related to the making of those supplies was readily explicable given that GST was not payable on an input taxed supply.[28]

In *HP Mercantile*, Hill J had offered an additional observation on the general policy for input taxed supplies:[29]

> "If it be necessary here to state a general policy for the application of the GST to enterprises making input taxed supplies, it would be that, to the extent that an entity carries on an enterprise that consists of making input taxed supplies, it will bear the GST on acquisitions without an input tax credit so that its pricing of outputs, if any are made, will take into account, commercially, all GST it will be required to bear on its inputs."

Davies J concluded, on the uncontroversial facts of the case, that the acquisitions in question all had a direct and immediate connection with the provision of the leased accommodation and that direct and immediate connection constituted a sufficient and material relationship for the purposes of s 11-15(2)(a).[30] This led to the full denial of input tax credits. It followed that the question of apportionment did not arise for determination because the acquisitions in question related wholly to the provision of the accommodation.[31]

It should be noted in passing that the outcome would have been no different if the accommodation had been provided for no consideration. While an input taxed financial supply must be made for consideration,[32] there is no requirement for consideration to be present for other input taxed supplies, such as the supply of residential accommodation.

The Full Federal Court Decision

Rio Tinto's submissions

On appeal, Rio Tinto maintained its contention that the proper application of s 11-15 entitled it to a credit to the full extent that its acquisitions related to the carrying on of its enterprise without denial of credit under s 11-15(2)(a).[33]

The Commissioner's submissions

The Commissioner's submissions do not appear from the judgment, though it is to be assumed they took the form of those presented in the court below, namely, that s 11-15(2)(a) applied because the acquisitions in question had a direct and immediate connection with the supply of residential accommodation by way of lease, being an input taxed supply.

Reasoning of the Full Federal Court

The court (Middleton, Logan and Pagone JJ) delivered an ex tempore judgment at the conclusion of the hearing of the appeal finding for the Commissioner without the need to hear from his counsel. The subsequently published short reasons for judgment were revised from the transcript. In these circumstances, it is possible that the reasons for judgment do not do full justice to the submissions of the parties.

The court began by noting that the structure of s 11-15 bears some similarity to the general business deductions provisions of the income tax law, but went on to say that "… care must be taken not to apply the jurisprudence on the income tax provisions as if they were the same as s 11-15 of the *GST Act*. There are significant differences between them".[34] The policy difference between the two provisions was articulated by Olding in the following terms:[35]

> "The differences in both the positive and negative limbs of s 8-1 of the ITAA 1997 and s 11-15, need to be considered in the light of the quite different policy purposes of the two provisions. The intent of income tax in relation to businesses is to tax income net of related expenses. The intent in GST is effectively not to tax the business at all, but rather to tax consumption expenditure. In this light, the purpose of the input tax credit is not to facilitate calculation of some sort of net profit on which GST is payable, but rather to offset the GST on supplies that are not final consumption. Accordingly, a nexus with making taxable supplies per se may be seen to be irrelevant to input tax credit entitlement. Subject to the limitations relating to input taxed supplies, the right to an

input tax credit arises as a matter of policy merely because the acquisition is not final consumption."

Returning to *Rio Tinto*, the Full Court stated:[36]

> "… the inquiry called for by s 11-15(2)(a) is not into whether something had been acquired in carrying on the enterprise (which would otherwise have acquired the thing for a creditable purpose within the meaning of s 11-15(1)) but, rather, irrespective of the extent to which the thing had been acquired in carrying on the enterprise, to what extent, if any, did the acquisition relate to making supplies that would be input taxed. The relationship to focus on, in other words, is the relationship between the antecedent acquisitions for which credit is claimed and the subsequent supply for which the credit is, in effect, lost.
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> The application of s 11-15(2)(a) requires, therefore, the precise identification of the relevant acquisition and a factual inquiry into the relationship between that acquisition and the making of supplies that would be input taxed. An acquisition will not be for a creditable purpose to the extent that the facts disclose that the acquisition relates to the making by the enterprise of supplies that would be input taxed."

This last paragraph should perhaps not be read too literally. In a large and complex business, it is often impractical to precisely identify each individual acquisition. The Full Court in *American Express* had previously recognised that, although "the GST Act uses language that is most appropriate for an analysis of individual acquisitions, an individual approach would be prohibitively inefficient for some taxpayers. For this reason, the Commissioner permits some taxpayers to analyse their acquisitions in the aggregate and no one has suggested that the Act does not in fact permit an aggregate approach".[37]

On the subject of apportionment, the Full Court in *Rio Tinto* observed:[38]

> "Some acquisitions may relate to the making of supplies that would be capable of distinct and separate apportionment as between an input taxed supply and an otherwise taxable supply. In that case it may be possible to divide the creditable purpose between the two. Other acquisitions may be indifferently both for supplies that would be both input taxed and otherwise taxable generally. In that case some fair and reasonable assessment of the extent of the relationship between the two may need to be made. But, as is the case here, an acquisition which relates wholly to the making of supplies that would be input taxed is not to be apportioned merely because that supply may also serve some broader commercial objective of the supplier. The contrary construction is neither required by the language of the provisions nor by its policy … An acquisition for purposes which are not distinct and severable or which does not relate to different supplies but which comes wholly within the blocking provision is excluded from the definition of creditable purpose."

The language closely mirrors that used in the "classic" case on apportionment, *Ronpibon Tin*, decided in the context of s 51(1) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), and in which the High Court said:[39]

> "It is perhaps desirable to remark that there are at least two kinds of items of expenditure that require apportionment. One kind consists in undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or producing assessable income and distinct and severable parts to some other cause. In such cases it may be possible to divide the expenditure in accordance with the applications which have been made of the things or services. The other kind of apportionable items consists in those involving a single outlay or charge which serves both objects indifferently. Of this directors' fees may be an example. With the latter kind there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income. It is an indiscriminate sum apportionable, but hardly capable of arithmetical or ratable division because it is common to both objects.
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> In such a case the result must depend in an even greater degree upon a finding by the tribunal of fact."

> *"… the terms of s 11-15(2)(a) did not depend on the reason or purpose of the enterprise making the supply …"*

The Full Court in *Rio Tinto* was of the opinion that all of the acquisitions in question "unquestionably" related wholly to the making of supplies that would be input taxed, albeit that they did so for the wider purpose of the enterprise. The acquisitions in this case were not like undifferentiated general overhead outgoings which, although undifferentiated, relate to different supplies, but were acquisitions of things which related wholly to the otherwise input taxed supply of residential premises, and could not relate to the broader purposes of the enterprise other than by the acquisitions relating to the otherwise input taxed supplies.[40]

Their Honours then put that another way: the extent of the relationship between the acquisitions and the supply of the residential premises was not to be reduced by the fact that the acquisitions may also have related to another purpose where that other purpose was only related to the acquisition wholly by and through the otherwise input taxed supply.[40]

On the subject of purpose, the court explained that the terms of s 11-15(2)(a) did not depend on the reason or purpose of the enterprise making the supply or making the anterior acquisition, but on a characterisation of the extent to which the acquisition related to the subsequent supply.[40]

Purpose and motive

The concepts of purpose and motive have been discussed extensively in the cases dealing with the availability of deductions under the general deduction provisions of the income tax law. That discussion is helpful, at a conceptual level at least, in understanding the relevance of purpose and motive in ascertaining creditable purpose under the GST law. A central case in the income tax discussion, *Magna Alloys*, involved the deductibility, under s 51(1) ITAA36, of legal expenses voluntarily paid by a company to defend its directors and agents on criminal charges arising out of the marketing methods used to sell the company's products.[41] An issue before the Full Federal Court was the relevance of the purpose of the expenditure in obtaining an income tax deduction. Brennan J, as he then was, observed that "motive and purpose are not novel or alien concepts in ascertaining deductibility under s 51(1), though their meaning is not always clear, and 'purpose' is susceptible of ambiguity".[42] His Honour went on to state:[42]

> "Motive means … the reason why a taxpayer decides to incur the expenditure. Purpose may be either a subjective purpose — the taxpayer's purpose — where it means the object which the taxpayer intends to achieve by incurring the expenditure; or it may be an objective purpose, meaning the object which the incurring of the

> expenditure is apt to achieve. Both motive and subjective purpose are states of mind and they are to be distinguished from objective purpose, which is an attribute of a transaction. An objective purpose is attributed to a transaction by reference to all the known circumstances; whereas subjective purpose and motive, being states of mind, are susceptible of proof not by inference alone but also by direct evidence, for a state of mind may be proved by the testimony of him whose state of mind is relevant to a fact in issue."

His Honour noted that, although references to motive and purpose were to be found in cases arising under s 51(1), neither motive nor either kind of purpose was a criterion of deductibility.[43] Turning to the case before him, his Honour stated:[44]

> "In the present case, the character and scope of the taxpayer's business is known without reference to its state of mind. Equally, it is objectively certain that the relevant expenditure was incurred to defray the legal costs of the directors and agents in the criminal proceedings brought against them. The connection between the legal services thus acquired and the taxpayer's business neither requires nor permits reference to the taxpayer's state of mind. The nature of that connection is to be found in the objective facts found by his Honour or not in dispute between the parties."

His Honour concluded that the expenditure was necessarily incurred in carrying on the company's business even though the expenditure was apt to serve both the business purpose and the purpose of defending the directors. Nor was the character of the expenditure lost because the principal or dominant reason for incurring the expenditure was to defend the directors.[45] The joint judgment of Deane and Fisher JJ stated the relevant question in composite form:[46]

> "The key to the role of the objective and subjective in such a formulation is, in the case of a voluntary outgoing, to be found in the statement of *Fullagar* J. in *F.C. of T. v. Snowden & Willson Pty. Limited (supra,* at p. 444) to which reference has already been made, namely, that 'within the limits of reasonable human conduct the man who is carrying on the business must be the judge of what is "necessary"'. The controlling factor is that, viewed objectively, the outgoing must, in the circumstances, be reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of the business being carried on for the purpose of earning assessable income."

It will be recalled that the Full Court in *Rio Tinto* noted that care must be taken not to apply the jurisprudence on the income tax provisions as if they were the same as s 11-15 as there are significant differences between them.[47] Nevertheless, the discussion of purpose and motive in the income tax cases, at least at a conceptual level, sheds some light on the relevance of those concepts in the GST provision.

It will also be recalled that Davies J in *Rio Tinto* stated that the purpose for which an acquisition was made may in some cases bear upon whether the acquisition has a relevant relationship with the making of supplies that would be input taxed.[48] Yet her Honour also observed that it is "the objective relationship" between an acquisition and making supplies that would be input taxed with which s 11-15(2)(a) is concerned.[48] It is respectfully suggested that there is no inconsistency in these statements, once it is understood that the reference to "purpose" is to objective purpose in the sense described by Brennan J, namely that an objective purpose is attributed to a transaction by reference to all the known circumstances.[49]

As the Full Court in *Rio Tinto* noted, the statutory concept of "creditable purpose" for GST does not textually depend on the reason or purpose of the enterprise making the supply or making the anterior acquisition.[50] The same may be said for income tax, and for the GST there may well be scope for the objective purpose attributable to a transaction to shed light on the relationship between an acquisition and the making of supplies that would be input taxed.

In the earlier case of *AXA Asia Pacific Holdings*, discussed in more detail later in this article, Lindgren J considered that s 11-15(2)(a) was objective and referred "to a relatedness as a matter of objective fact between an acquisition and a supply".[51]

It should perhaps be added that there is nothing in the Div 129 adjustment provisions, relating to changes in the extent of creditable purpose, that changes the analysis. Division 129 contains a complex set of provisions which are most often ignored in practice. In broad terms, where there is a change in creditable purpose, an adjustment is made based on the difference between the "actual application of the thing" and the "intended or former application of the thing".[52] The "intended" application of the thing seems to suggest that intention might be relevant but, like the concept of creditable purpose itself, is a statutory construct. If you have not previously made an adjustment, it is simply "the extent (if any) to which you acquired … the thing for a creditable purpose".

Creditable purpose – a "two-step" approach

As is apparent from the discussion so far, there is essentially a "two-step" approach in determining creditable purpose.

Hill J observed in *HP Mercantile* that the first step is to pass through a positive test, being a requirement that the acquisition has been in whole or in part acquired in carrying on an enterprise. In *Rio Tinto*, Davies J considered that whether an acquisition was *connected* with the activities that constitute the entity's "enterprise" will depend on the scope of the activities that constitute the entity's "enterprise".[53] It should be noted at once that this is not the same thing as relating the acquisition to a taxable, GST-free or "out of scope" supply.

The second step is then to consider the negative tests which exclude the allowance of a credit in the GST context relating to supplies that would be input taxed or acquisitions of a private and domestic nature.[54] It is the second step that has caused most comment and difficulty. This seems to have arisen exclusively in the context of input taxed supplies, perhaps because acquisitions of a private and domestic nature are rarely related to the enterprise in the first place. The disentitling words "to the extent that … the acquisition relates to making supplies that would be input taxed" contain three difficult concepts, being relational, temporal and fractional.

The relational concept

In *Rio Tinto*, Davies J pointed out that the words "relates to" in s 11-15(2)(a) must be given a meaning that depends on the context in which they are used and that the relationship must be one that is "sufficient" or "material".[55] Davies J concluded that the acquisitions made by Rio Tinto all had a direct and immediate connection with the provision of the leased accommodation and that the direct and immediate connection constituted a sufficient and material relationship for the purposes of s 11-15(2)(a).[56]

The Full Court in *Rio Tinto* reached the same conclusion. The extent of the relationship between the acquisitions and the supply of the residential premises was not to be reduced by the fact that the acquisitions may also have related to

another purpose where that other purpose was only related to the acquisition wholly by and through the otherwise input taxed supply.[57]

The relationship between the acquisition and the making of supplies that would be input taxed was the subject of detailed comment by Hill J in *HP Mercantile* in the following passages:[58]

> "There seemed to be no real disagreement between the parties as to the nature of the relationship required. Both parties appeared to accept that the relationship was one which had to be a 'real' and substantial relationship – not one that was trivial. There was some discussion on the question whether the relationship could be indirect or had to be direct, although it did not seem that anything turned upon that in the submissions of the Trustee.
>
> It was common ground that the words 'relates to' are wide words signifying some connection between two subject matters. The connection or association signified by the words may be direct or indirect, substantial or real. It must be relevant and usually a remote connection would not suffice. The sufficiency of the connection or association will be a matter for judgment which will depend, among other things, upon the subject matter of the enquiry, the legislative history, and the facts of the case. Put simply, the degree of relationship implied by the necessity to find a relationship will depend upon the context in which the words are found …
>
> That the relationship contemplated here might be indirect follows, probably from s 11-15(5), which provides that an acquisition will not be treated as relating to supplies that are input taxed where the acquisition relates to making a financial supply which consists of a borrowing and the borrowing relates to the taxpayer making supplies that are not input taxed. Hence, input tax credits will not be disallowed if the acquisition which gives rise to them relates to the taxpayer making a borrowing but the borrowing is used by the taxpayer in making taxable or GST free supplies. In other words, s 11-15(5) would appear to contemplate that an acquisition having an indirect connection with a financial supply would otherwise falls within s 11-15(2)(a) …
>
> It follows, perhaps more clearly, as well from the requirement of apportionment to be found in the words 'to the extent that' which indicate that an acquisition may relate to the making of supplies that are input taxed as well as supplies that are taxable, as would be the case with undifferentiated general overhead outgoings of an entity making both input taxed and taxable supplies …
>
> Whatever may be the case where a relationship is indirect, that is not the case here. Once it is accepted that what is required is a real or substantial relationship, it becomes then a question of fact whether such a relationship exists in a particular case …
>
> The next matter to be noted is that the relationship must be one that relates to 'making' supplies that are input taxed, not one that relates to the supplies themselves. It is difficult to see that anything turns upon that in the present case."

Two aspects of the relational concept were discussed further in *AXA Asia Pacific Holdings*:[59] first, the extent to which the relationship can be indirect; and second, whether an indirect relationship can extend to "looking through" a related entity. AXA was the representative member of a GST group. The proceedings were concerned with a member of that group, The National Mutual Life Association of Australasia Ltd (NMLA), which carried on business as an insurer with retail activities comprising both life insurance and non-life insurance business.

> *"… you cannot 'look through' an entity to establish a relationship between an acquisition and a supply."*

Pursuant to a statutory requirement, the life insurance business was conducted within one or more separate statutory funds. The investments of any of those funds could be used only to meet the liabilities and expenses incurred for the purposes of the business of that fund, to make investments in a way that is likely to further the business of that fund, or for the purposes of distribution when certain solvency and capital adequacy requirements are met. There was evidence of the composition of the respective statutory funds and of the categories of assets within each. One of those categories was "unit trusts", being investments by NMLA through a holding of units in a unit trust which usually invested in real property or shares.[60]

The issue was whether NMLA acquired certain things for a creditable purpose and was therefore entitled to input tax credits in respect of those things. This question, in turn, raised the question of whether NMLA was denied input tax credits by reason of the fact that the acquisitions related to the making of supplies that would be input taxed.

It was common ground that in the case of at least some of the overseas investments made by unit trusts in which NMLA invested, if NMLA had made those overseas investments directly, rather than through the unit trusts, there would have been GST-free supplies which would not have blocked NMLA's entitlement to input tax credits in respect of certain overhead costs related to those investments.[61]

In affidavit evidence, AXA's taxation manager took the approach that in calculating the revenue referable to investments in unit trusts, a "look-through" approach should be adopted on the basis that NMLA was an active investor with controlling interests in almost all of its unit trust investments, with the unit trust serving merely as a convenient vehicle for holding the investments. Accordingly, it was said, revenue derived through holding revenue units in a unit trust should be treated in the same way as if it had been derived directly by NMLA.[62]

Lindgren J commenced his reasoning on this issue by stating:[63]

> "The distinction that the Act makes between an entity in its personal capacity, the entity in its capacity as trustee, and the entity constituted by a trust itself as described above seems to go a long way to contradicting any look through approach."

His Honour noted that AXA's argument appeared to be that the Act allowed for an acquisition to be related indirectly to a supply, and that where the actual purpose of AXA in investing in a unit trust was to make overseas investments, that actual purpose should be determinative.[64] However, his Honour concluded that the look-through approach was "inconsistent with the Act",[65] and speaking of s 11-15 stated:[66]

> "Subsection (1) invokes an objective notion. One might perhaps have hoped for a more apt expression than 'creditable purpose' to refer to the simple notion of an acquisition in the course of the carrying on of an enterprise. The expression 'the acquisition relates to supplies that would be input taxed' in para (a) of s11-15(2) is likewise objective: it refers to a relatedness as a matter of objective fact between an acquisition and a supply."

His Honour then referred to the relevant extract from the explanatory memorandum which accompanied the GST Bill:[67]

> "… you are not entitled to an input tax credit for acquiring a thing if your acquisition of the thing relates to an input taxed supply you are going to make. No tax will be charged on that supply. Therefore, you do not have a creditable purpose if your acquisition of a thing relates, either directly or indirectly, to a supply you make that is input taxed."

In an important passage, his Honour therefore concluded:[68]

> "The extent to which NMLA acquired the things … for a creditable purpose is therefore answered by looking to the extent to which those things were acquired in the carrying on of NMLA's enterprise, and then to the extent that the acquisitions **related, directly or indirectly, to the making of any input taxed supplies by NMLA**. Neither the subjective intention of NMLA, nor the activities of [the] trustees of the unit trusts, is determinative of these questions." (emphasis in original)

It seems clear from both *HP Mercantile* and *AXA Asia Pacific Holdings* that an input tax credit is blocked, at least in part, to the extent that the acquisition has even an indirect relationship to the making of an input taxed supply. It is also clear from *AXA Asia Pacific Holdings* that you cannot "look through" an entity to establish a relationship between an acquisition and a supply. Perhaps that is all the more so when the relevant relationship sought to be identified is between an acquisition and a taxable supply, rather than between an acquisition and an input taxed supply.

The temporal concept

HP Mercantile was a case in which the temporal concept in s 11-15(2)(a) was in issue and in which the appellant had submitted that the paragraph operated to disallow input tax credits only where the acquisition related to a future supply. This was said to flow from the words "that *would be* input taxed" (emphasis added) which imported a meaning of "conditional futurity".[69]

Hill J rejected the appellant's submission:[70]

> "There is no reason in principle or policy why the grant of input tax credits should depend upon the sequence in which acquisition and supply occur. In the real world, while often, perhaps normally, acquisitions will precede supplies to which they are related, this is not inevitably the case … All that is required is a relationship between the acquisition and the making of supplies that, if any are made, would be input taxed."

As was characteristic of his Honour, he convincingly explained his conclusion by reference to the underlying policy of the provision:[71]

> "… there was a need in framing a provision disentitling a taxpayer to input tax credits to use a word suggesting conditionality, to ensure that a credit would not be available if there would have been a relationship between the acquisition and a future supply, in the event that no future supply eventuated. A simple example would be the case of acquisitions relating to establishing a financial institution which collapsed before making any supply. Had a supply been in fact made by that financial institution, it may be assumed the supply would have been a financial supply. Such a case would necessarily be encompassed by the words: 'the acquisition relates to making supplies that would be input taxed.'"

In the context of *Rio Tinto*, it might be expected that the temporal concept will have some relevance at the end of the life cycle of the residential accommodation and infrastructure associated with mining operations. Expenditure on acquisitions related to the demolition of buildings and site remediation are examples. While everything is fact dependent, it can safely be said that the fact that such expenditure falls later than the making of the input taxed supplies will not of itself be relevant. Perhaps more relevant will be the notion of "carrying on" an enterprise, central to s 11-15(1), which includes doing anything in the course of termination of the enterprise.[72]

The fractional concept

It will be recalled that s 11-30(3) defines the "extent of creditable purpose" as "the extent to which the creditable acquisition is for a creditable purpose, expressed as a percentage of the total purpose of the acquisition". The author has described this as a fractional concept because of the statutory requirement to express the extent of creditable purpose as a percentage, a requirement absent from the income tax provision. The concept of apportionment in income tax is well understood.[73]

Rio Tinto is ultimately not a case about apportionment, but tells us when apportionment is not available at all. As the Full Court noted: "An acquisition for purposes which are not distinct and severable or which does not relate to different supplies but which comes wholly within the blocking provision is excluded from the definition of creditable purpose".[74]

Methods of apportionment, whether revenue or otherwise, usually represent proxies for the extent to which acquisitions relate to a creditable purpose.[75] In the case of a revenue proxy, it is common to derive the extent of creditable purpose as a fraction which has revenues from taxable, GST-free and "out of scope" supplies in the numerator, and revenues from all supplies in the denominator. This is what Axa Asia Pacific Holdings, American Express and Rio Tinto all sought to do with their revenue proxy formulae. But as *Rio Tinto* illustrates, that may run the risk of truncating the way the statute operates.

Rio Tinto's alternative submission on apportionment implicitly assumed that the acquisitions bore some relationship to both taxable and GST-free supplies on the one hand, and to input taxed supplies on the other.

In the world of proxy formulae, it is common to relate an acquisition to a particular character of supply, either as "creditable" in the case of taxable, GST-free or "out of scope" supplies, or as "non-creditable" in the case of input taxed supplies. Davies J used similar language in *Rio Tinto*: "An apportionment is required to the extent that an acquisition has a relevant relationship with both the making of taxable supplies and input taxed supplies, such as where there are undifferentiated general overhead outgoings".[76] In the statute, however, there is never an enquiry directed to whether an acquisition has a relationship to making a taxable supply.[77] It is important to first undertake the "two-step" process described above. If, as a result of that process, the acquisition is wholly "blocked", there can be no apportionment in relation to it.

It would be different if, for example, one was considering an acquisition of an electricity service where the electricity powered both the mine site and the residential accommodation located near that site. The acquisition would clearly relate to the enterprise and so the first step would be satisfied without the need for an apportionment. However, it could not be said that the acquisition wholly related to the supply of residential accommodation, as it clearly related to the mining enterprise in a way other than through the supply of residential accommodation. The second step would therefore also be satisfied, but with the need for an apportionment.

The most helpful discussion of apportionment in the context of GST is

that by Lindgren J in *AXA Asia Pacific Holdings*. The things acquired by NMLA had been variously described as "general management expenses" (GME), "general administrative expenses" and "overheads". His Honour considered these to be loose descriptions on the basis that an expense or overhead is not a thing acquired, but for convenience conformed to the parties' usage of GME.[78] AXA claimed that its GME was incapable of being allocated to distinct identifiable supplies, although no evidence was specifically directed to showing this. The particular question posed, therefore, concerned the extent to which the GME of NMLA related to the making of supplies that would be input taxed.

In the course of its business activities, NMLA incurred expenses in acquiring things, some of which bore GST (such as commissions) and some of which did not (such as wages and salaries paid to NMLA's employees). Some of the expenses were identifiable as relating directly to input taxed supplies, taxable supplies, GST-free supplies, and "out of scope" supplies. An example of directly attributable expenses was commissions paid to independent sales agents in connection with the promotion and sale of NMLA's products. Such expenses were not in issue in the proceedings.

According to the evidence, the GME included staff salaries, staff on-costs, travel and accommodation, training and recruitment, rent, other occupancy costs, telephone, postage, advertising and audit fees, and could not be directly attributed to particular activities of NMLA.

The Commissioner contended that none of the apportionment methodologies submitted by AXA were appropriate, and that it would be necessary for the parties to approach the question of an appropriate apportionment methodology de novo in light of the court's reasons on the various questions of law addressed by it.

Lindgren J thought it appropriate to indicate that in a case of apportionment of GME under s 11-30, "ideally the evidence would specify the nature and use made of the things acquired in some detail, the attempts made to relate them directly to supplies, and the reason why the particular methodology and proxies proposed are most likely to approximate the relatedness between acquisition of the things and the use made of them".[79]

The apportionment issue was not addressed further as the matter was listed for further directions in light of the court's reasons on the various rulings of law made by it.

The asymmetry issue

There is an asymmetry in the way that acquisitions relating to input taxed supplies and acquisitions relating to other supplies are treated. As has been observed, an important aspect of the "two-step" approach described above is that while there may be an enquiry directed to whether an acquisition has a relationship to an input taxed supply, there is never an enquiry directed to whether an acquisition has a relationship to making a taxable, GST-free or "out of scope" supply.

> *"... there is never an enquiry directed to whether an acquisition has a relationship to making a taxable, GST-free or 'out of scope' supply."*

Some commentators have posed the question of whether input tax credits would be denied if an acquisition related directly to the making of a taxable supply in circumstances where the primary commercial activities of the taxpayer were input taxed.[80] That is a reasonable question, though it does seem to assume as its starting point that there is some relevance between an acquisition and its relationship with a taxable supply. That assumption is questionable.

Section 11-15(1) tells us that the first step is to determine whether an acquisition has been acquired to any extent in carrying on an enterprise. It should be observed that the statute does not ask whether the acquisition "relates to" the enterprise in question, let alone whether that relationship might be direct or indirect (as contemplated by s 11-15(5) in the context of s 11-15(2)). The nature of the relationship between the acquisition and the enterprise was not explored in *Rio Tinto* as the Commissioner had accepted that the acquisitions had been made in the course of carrying on an enterprise.

Consider the following example which, in terms of the nature of the supplies made, is the reverse of *Rio Tinto*. Suppose a bank wholly makes input taxed supplies. The bank constructs a gym for the benefit of its employees to whom it charges a modest fee at a subsidised price. The supply of gym services is taxable.

Applying the "two-step" approach, there would be little doubt in step one that the acquisitions of things necessary to construct the gym would be acquired by the bank in carrying on its enterprise. Similar to *Rio Tinto*, the positive test in s 11-15(1) would be satisfied.

The second step is to consider the negative test in s 11-15(2)(a) and determine whether the acquisitions relate, either directly or indirectly, to the making of any input taxed supplies by the bank.[81] The acquisitions could be said to relate directly to the making of taxable supplies in the same way that the acquisitions in *Rio Tinto* related directly to input taxed supplies. However, it is not relevant to ask whether the acquisitions relate to the making of taxable supplies. The question posed by the statute is whether the acquisitions relate, either directly or indirectly, to the making of any input taxed supplies. The author contends that the acquisitions relate at least indirectly to the making of input taxed supplies, and that is sufficient to engage the terms of s 11-15(2)(a). A question would remain about the extent to which the acquisitions relate to the input taxed supplies and that question is one of fact. The inescapable conclusion, however, is that there would be some level of input tax credit denial.

It should be understood that the facts in *Rio Tinto* and in the bank gym example have an unusual feature. In most cases involving apportionment, there is an enquiry into the relationship between an input of the enterprise and one or more outputs of the enterprise. In both *Rio Tinto* and the bank gym example, however, there is an enquiry into the relationship between an input of the enterprise and an intermediate output of the enterprise, which is itself an input into the overall enterprise. As the decision in *Rio Tinto* illustrates, where an intermediate output is input taxed, it is more likely to lead to full input tax credit denial. This important feature

of *Rio Tinto* needs to be considered when analysing other fact patterns and is certain to be discussed in future cases.

It might be recalled that the Full Court in *Rio Tinto* expressed this more eloquently: the extent of the relationship between the acquisitions and the supply of the residential premises was not to be reduced by the fact that the acquisitions may also have related to another purpose, where that other purpose was only related to the acquisition wholly by and through the otherwise input taxed supply.[82]

An example: relational, temporal and fractional

The following example, well known to practitioners, illustrates the relational, temporal and fractional concepts embodied within s 11-15(2)(a).

Potential takeover – part one

A company that otherwise makes only taxable supplies acquires merchant banking services (a taxable supply by the bank) to advise on the merits of a potential takeover of a target company. The bank is to have regard to a range of factors, including the profitability and forecast earnings of the target company and the potential for cost savings in combining the back office operations of the two entities. The bank delivers a report summarising its conclusions and issues a tax invoice in respect of its services. To what extent, if any, is the acquisition of merchant banking services to advise on the merits of a takeover for a creditable purpose?

Potential takeover – part two

The bank advised in its report that there was merit in the company proceeding with a takeover of the target company and is now asked to advise on options on how to proceed. The structure of the proposed acquisition, whether by way of an acquisition of assets (a taxable supply by the vendor) or shares (an input taxed supply by both the shareholder and the company), is not settled. Each is presented as an option in a further report delivered by the bank which is accompanied by a second tax invoice. Assume that only 20% of proposed takeovers proceed (it is commonplace that most proposed takeovers do not go ahead). Assume further that the company is indifferent to the form of the transaction and that a share acquisition is as equally likely as an asset purchase. To what extent, if any, is the acquisition of merchant banking services to advise on options for a creditable purpose?

Potential takeover – part three

The bank is now asked by the company to assist in acquiring shares "on-market" in the target company. It takes preparatory steps to do so but before entering into any agreements to purchase shares, the share market moves significantly. The company decides not to proceed with the takeover. The bank issues a final tax invoice. To what extent, if any, is the acquisition of merchant banking services to assist in acquiring shares for a creditable purpose?

Potential takeover – part one discussion

It is important again to use the "two-step" approach. There is no doubt that the acquisition of merchant bank services by the company to advise on the merits of a takeover would be acquired by the company in carrying on its enterprise. The positive test in s 11-15(1) would be satisfied.

The second step is, therefore, to determine whether the acquisition relates, either directly or indirectly, to the making of any input taxed supplies by the company. The Full Court in *Rio Tinto* reminded us that the application of s 11-15(2)(a) requires the precise identification of the relevant acquisition and a factual enquiry into the relationship between that acquisition and the making of supplies that would be input taxed. The only possible input taxed supply would be the supply of shares in the event that a takeover ultimately proceeded by way of share sale.

What sort of relationship, if any, exists between the acquisition of services and the possible supply of shares? Davies J in *Rio Tinto* considered that the relationship must be one that is "sufficient" or "material". It was common ground in *HP Mercantile* that the relationship may be direct or indirect, substantial or real, but that usually a remote connection would not suffice.

On these facts, it is the author's view that the acquisition of services examining the merits of a potential takeover is objectively too remote from any possible acquisition of shares. The company is at this stage only considering possibilities, no decision has been made to proceed, and the form of any transaction is yet to be considered, if at all. The acquisition would therefore be for a creditable purpose.

Before proceeding further, it is worth exploring here whether it is possible to take an alternative view based on the *probability* of the transaction proceeding. Suppose, for example, that it can be said that the probability of such a transaction proceeding by way of share sale is 5%. Does this mean that there can be said to be the requisite relationship between the acquisition and the possible input taxed supply? Does it mean further that the extent of the creditable purpose must be 5%?

In the author's view, there is a difficulty in approaching s 11-15(2)(a) in such a way. There is a difference between whether, and to what extent, a relationship exists. "Whether" a relationship exists requires a qualitative assessment, hence descriptions such as "sufficient", "material", "substantial", "real" or "remote". "To what extent" a relationship exists requires a quantitative assessment, hence the statutory requirement that the extent to which a creditable acquisition is for a creditable purpose be expressed as a percentage. Both the relational and fractional concepts exist within the statutory provision but each should not be confused with the other.

Accordingly, the probability that an input taxed supply might be made should not of itself determine the qualitative assessment of the sufficiency of the relationship between an acquisition and a possible supply. Once a conclusion is reached that the relevant relationship is too remote, there is then no need to ask about the extent of the relationship. The fact that the probability of a transaction proceeding by way of share sale is 5% should not of itself mean that the requisite relationship has been established, still less that the extent of creditable purpose must be 5%.

Potential takeover – part two discussion

There is again no doubt that the acquisition of merchant bank services by the company to advise on takeover options would be acquired by the company in carrying on its enterprise, and the positive test in s 11-15(1) would be satisfied.

The relevant question is, therefore, whether the acquisition relates, either directly or indirectly, to the making of any input taxed supplies by the company. Again, the only possible input taxed supply would be the supply of shares in the event that a

takeover ultimately proceeded by way of share sale.

At this stage of the proposed takeover, the company is still considering options, has made no decision to proceed with an acquisition, and is indifferent to the form any transaction might take. It is again the author's view that the acquisition of services to advise on takeover options is objectively too remote from any possible supply of shares. The acquisition would therefore be for a creditable purpose.

It should be noted that the probability the proposed takeover would proceed by way of share sale is 10% (20% chance of proceeding x 50% chance of share sale). As discussed above, however, the fact that the probability of a transaction proceeding by way of share sale is 10% should not of itself mean that the requisite relationship has been established.[83]

Potential takeover – part three discussion

The acquisition of merchant banking services by the company to assist in acquiring shares would be acquired by the company in carrying on its enterprise, and the positive test in s 11-15(1) would be satisfied.

Again, the only possible input taxed supply to which the acquisition might relate would be the supply of shares in the event that a takeover ultimately proceeded by way of share sale.

The proposed transaction has progressed. The company is no longer merely considering possibilities and options, but has effectively made a decision to proceed. The form of the transaction is settled and the bank has been instructed to make an "on-market" purchase of shares. These objective factors inform the qualitative assessment that needs to be made of whether the requisite relationship exists. In the author's opinion, there is a sufficient or material, rather than remote, relationship between the acquisition of the services to assist in acquiring shares and the potential acquisition of the shares themselves. The acquisition would, therefore, not be for a creditable purpose to any extent.

That conclusion can be reached irrespective of whether the transaction proceeds or not. This is the temporal issue found in the expression "would be input taxed" which was addressed by Hill J in *HP Mercantile*. As will be recalled, s 11-15(2)(a) was framed in such a way "to ensure that a credit would not be available if there would have been a relationship between the acquisition and a future supply, in the event that no future supply eventuated".[84]

In some respects, it might be said that to look at whether the transaction actually completes is irrelevant and misleading. One must surely make the qualitative assessment at the time the acquisition is made. There is no suggestion that s 11-15 is a "wait and see" provision.[85] Nor does a subsequent adjustment under Div 129 appear likely where the acquisition is largely advice or services rendered and which are consumed at the time of acquisition. There is no subsequent "actual application of the thing" as there might be with a durable asset whose use changes over time.[86] No doubt evidence of the outcome of a transaction may have some relevance in objectively determining the qualitative nature of the relationship at the time of acquisition, but it should not be determinative.

> *"Rio Tinto is unlikely to be the last judicial foray into the statutory construct of creditable purpose ..."*

Conclusion

The progression of cases from *HP Mercantile* to *Rio Tinto* continues to shed light on the meaning of "creditable purpose", a unique provision with no real analogue in the GST/VAT world. So what does *Rio Tinto* tell us about creditable purpose?

First, "creditable purpose" is a statutory construct which has a specific statutory meaning and does not use the language of, or require, or even direct, an enquiry into purpose. To speak of purpose in this context is to speak of an objective relationship. Second, the extent of the relationship between an acquisition and an input taxed supply is not to be reduced by the fact that the acquisition may also have related to another purpose, where that other purpose is only related to the acquisition wholly by and through the otherwise input taxed supply. *Rio Tinto* therefore confirms when apportionment is not available at all, namely, where the acquisition does not relate to different supplies, but comes wholly within the blocking provision. Third, the fact that an input taxed activity is loss making does not prevent a denial of input tax credits.

The author respectfully adds some further considerations on the meaning of "creditable purpose". First, s 11-15 involves a "two-step" process and it is important not to truncate this process as may happen with an apportionment methodology based on revenue. Second, the second step of the process contains three difficult concepts, being relational, temporal and fractional. The relational aspect is asymmetrical in the way that acquisitions relating to input taxed supplies and acquisitions relating to other supplies are treated. While there may be an enquiry directed to whether an acquisition has a relationship to an input taxed supply, there is never an enquiry directed to whether an acquisition has a relationship to making a taxable, GST-free or "out of scope" supply. Third, there is a difference between whether, and to what extent, a relationship exists. "Whether" a relationship exists requires a qualitative assessment and the probability that an input taxed supply might be made should not of itself determine the sufficiency of the relationship between an acquisition and a possible supply. "To what extent" a relationship exists requires a quantitative assessment. Care must be taken not to confuse the relational and fractional concepts. Fourth, s 11-15 is not a "wait and see" provision; the qualitative assessment should be made at the time of the relevant acquisition.

These considerations have important implications for the GST treatment of acquisitions relating to the making of input taxed supplies, especially in the financial services and residential property sectors, and particularly in the day-to-day world of transactions.

Rio Tinto is unlikely to be the last judicial foray into the statutory construct of creditable purpose, especially as that case involved an enquiry into the relationship between an input and an intermediate output, though the decision enables us to place a few more pieces into the GST jigsaw puzzle.

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3 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [16].

4 Ibid at [19].

5 Ibid at [19].

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8 Ibid at [18].

9 *Commissioner of Inland Revenue v BNZ Investment Advisory Services Ltd* (1994) 16 NZTC 11,111.

10 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [20].

11 Ibid at [21].

12 Ibid at [21].

13 *HP Mercantile Pty Ltd v FCT* [2005] FCAFC 126 at [22]. See also *Axa Asia Pacific v FCT* [2008] FCA 1834 at [124] per Lindgren J.

14 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [23].

15 Ibid at [24], citing *Amalgamated Zinc (De Bavay's) Ltd v FCT* [1935] HCA 81; *FCT v Day* [2008] HCA 53; *HP Mercantile Pty Ltd v FCT* [2005] FCAFC 126 at [13] and [48]. This would appear to be reinforced by the definition of the expression "carrying on" as "including doing anything *in the course of* the commencement or termination of the enterprise" (emphasis added): s 195-1.

16 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [24].

17 *FCT v American Express* (2010) 187 FCR 398 at [104]-[105].

18 To this should be added "out of scope" supplies, such as those not connected with the "indirect tax zone" pursuant to s 9-25 and which are thus beyond the scope of the GST law.

19 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [25], citing s 11-30 and *HP Mercantile Pty Ltd v FCT* (2005) 143 FCR 553 at [37].

20 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [26], citing *HP Mercantile Pty Ltd v FCT* [2005] FCAFC 126 at [46]. Lindgren J rightly described s 11-15(2)(a) as a "blocking provision" in *AXA Asia Pacific Holdings Ltd v FCT* [2008] FCA 1834 at [38].

21 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [26].

22 Para 5.164 of the explanatory memorandum to the A New Tax System (Goods and Services Tax) Bill 1998 (Cth).

23 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [27].

24 *HP Mercantile Pty Ltd v FCT* [2005] FCAFC 126 at [13] and [45].

25 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [29].

26 Ibid at [30], citing *Certain Lloyd's Underwriters Subscribing to Contract No IH00AAQS v Cross* (2012) 248 CLR 378 at [26] per French CJ and Hayne J.

27 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [31].

28 Ibid at [32]. This borrows from a well-known income tax concept: "The Act must operate upon the result of a taxpayer's activities as it finds them": *Tweddle v FCT* (1942) 7 ATD 186 at 190 per Williams J; in a GST context, see also *FCT v Luxottica Retail Australia Pty Ltd* [2011] FCAFC 20 at [39] per Ryan, Stone and Jagot JJ.

29 *HP Mercantile Pty Ltd v FCT* [2005] FCAFC 126 at [50].

30 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [33].

31 Ibid at [34].

32 Reg 40-5.09(1)(a)(i) of *A New Tax System (Goods and Services Tax) Regulations 1999* (Cth).

33 *Rio Tinto Services Ltd v FCT* [2015] FCAFC 117 at [5].

34 Ibid at [4].

35 R Olding, "An ATO perspective on the creditable purpose test" (2012) 12 AJGST 131 at 135.

36 *Rio Tinto Services Ltd v FCT* [2015] FCAFC 117 at [6] and [7].

37 *FCT v American Express International Inc* [2010] FCAFC 122 at [78] per Kenny and Middleton JJ.

38 *Rio Tinto Services Ltd v FCT* [2015] FCAFC 117 at [7].

39 *Ronpibon Tin NL v FCT* (1949) 78 CLR 47 at 59.

40 *Rio Tinto Services Ltd v FCT* [2015] FCAFC 117 at [8].

41 *Magna Alloys & Research Pty Ltd v FCT* (1980) 80 ATC 4542. A fuller discussion of the relevance of the purpose of expenditure for income tax deductibility can be found in R Parsons, *Income taxation in Australia*, The Law Book Company Ltd, 1985, from para [6.2].

42 *Magna Alloys & Research Pty Ltd v FCT* (1980) 80 ATC 4542 at 4544.

43 Ibid at 4545.

44 Ibid at 4552.

45 Ibid at 4553.

46 Ibid at 4559.

47 *Rio Tinto Services Ltd v FCT* [2015] FCAFC 117 at [4].

48 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [26].

49 *Magna Alloys & Research Pty Ltd v FCT* (1980) 80 ATC 4542 at 4544.

50 *Rio Tinto Services Ltd v FCT* [2015] FCAFC 117 at [8].

51 *AXA Asia Pacific Holdings Ltd v FCT* [2008] FCA 1834 at [124].

52 S 129-40(1).

53 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [24].

54 *HP Mercantile Pty Ltd v FCT* [2005] FCAFC 126 at [21]; see also *Axa Asia Pacific v FCT* [2008] FCA 1834 at [124] per Lindgren J.

55 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [26], citing *HP Mercantile Pty Ltd v FCT* [2005] FCAFC 126 at [46].

56 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [33].

57 *Rio Tinto Services Ltd v FCT* [2015] FCAFC 117 at [8].

58 *HP Mercantile Pty Ltd v FCT* [2005] FCAFC 126 at [35]-[40].

59 *AXA Asia Pacific Holdings Ltd v FCT* [2008] FCA 1834.

60 Ibid at [6].

61 Ibid at [30].

62 Ibid at [82].

63 Ibid at [120].

64 Ibid at [121].

65 Ibid at [122].

66 Ibid at [124].

67 Para 3.26 of the explanatory memorandum to the A New Tax System (Goods and Services) Tax Bill 1998 (Cth), cited in *AXA Asia Pacific Holdings Ltd v FCT* [2008] FCA 1834 at [126].

68 *AXA Asia Pacific Holdings Ltd v FCT* [2008] FCA 1834 at [127].

69 *HP Mercantile Pty Ltd v FCT* [2005] FCAFC 126 at [25] and [29].

70 Ibid at [52].

71 Ibid at [42].

72 S 195-1.

73 On apportionment in a GST context more generally, see O'Rourke, "The legal framework for GST apportionment by financial suppliers", UNSW ATAX GST Conference, April 2009; and C Sievers, "Be reasonable – apportion it my way", (2015) 15 AGSTJ 49.

74 *Rio Tinto Services Ltd v FCT* [2015] FCAFC 117 at [7].

75 *FCT v American Express International Inc* [2010] FCAFC 122 at [124] per Kenny and Middleton JJ.

76 *Rio Tinto Services Ltd v FCT* [2015] FCA 94 at [25], citing s 11-30 and *HP Mercantile Pty Ltd v FCT* [2005] FCAFC 126 at [37].

77 *Trustee of the Family Trust and FCT* [2010] AATA 876 at [12] per Senior Member Frost.

78 [2008] FCA 1834 at [16].

79 Ibid at [75].

80 G Lazanas and R Thomas, "Rio Tinto Services Limited – no input tax credit relief" (2015) 15 AGSTJ 40 at 47; see also M Strauch, "Sticking to the facts – creditable purpose after Rio Tinto", Tax Institute 2015 National GST Intensive, p 13.

81 The acquisitions would not be considered to be private or domestic in nature.

82 *Rio Tinto Services Ltd v FCT* [2015] FCAFC 117 at [8].

83 The Commissioner takes the view, in a fact sheet rather than a public ruling, that the probability that a transaction is successful is not relevant at all: see ATO, "Mergers and acquisitions – claiming input tax credits", June 2015. Available at www.ato.gov.au/business/gst/in-detail/rules-for-specific-transactions/business-asset-transactions/mergers-and-acquisitions---claiming-input-tax-credits.

84 *HP Mercantile Pty Ltd v FCT* [2005] FCAFC 126 at [42].

85 Compare Div 99; and see *FCT v Reliance Carpet Co Pty Ltd* (2008) 236 CLR 342 at 354.

86 S 129-40(1); see also the meaning of "apply" in s 129-55. The Commissioner broadly agrees with this view: see GSTD 2012/3.