



# **Negotiating development property deals:** The critical conditions

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## 1 INTRODUCTION

Negotiation and contractual arrangements in relation to development properties can take many forms. These can include:

- Contracts for the sale and purchase of the property;
- Option agreements – put options, call options and put and call options;
- Joint venture agreements; and
- Development agreements.

The list above merely identifies or puts a name to a number of the traditional arrangements by which a landowner and a purchaser or developer enter into contractual arrangements to deal with development property. Many arrangements will have no such label but the intention remains the same – for the parties to come to terms in relation to dealing with development property.

This paper examines some specific issues in relation to those agreements. In this context and in this paper, “development property” refers to a property on which development may take place at some stage in the future, and in this paper “development property agreements” is a reference to all of the types of agreements referred to above.

Development properties can vary in type from broadacres on which there is no current development approval (where all of the development related activities are intended to take place after the agreement has been entered into), to those properties where a significant amount of development has already taken place but is yet to be completed.

The current economic climate may lend itself to the availability of development properties in “distressed sale” circumstances; particularly those where construction is a significant way towards completion. This, together with initiatives such as the Victorian Government’s “Melbourne 2030: a planning update, Melbourne @ 5 million” will mean a continuing necessity for practitioners acting for land owners and developers alike to be aware of the particular issues that arise in negotiations and contractual arrangements regarding development properties.

It should be noted that the issues discussed in this paper are not, and cannot by their very nature, be exhaustive. Issues will always arise in relation to the particular negotiations and arrangements between the parties, together with the property itself. In all circumstances a comprehensive assessment of the relevant issues must be undertaken.

## 2 GST

This paper does not propose to give an update of the current state of the law in relation to GST and property development.

Two relevant issues which arise in the context of development property agreements are:


- Who has standing to object in relation to a decision made by the Australian Taxation Office regarding a GST liability?
- How can the GST going concern exemption apply to the sale of development properties?

### 2.1 GST – who can object?

A development property agreement (in particular the contract of sale) will generally provide that the sale, if it constitutes a taxable supply, will either be inclusive or exclusive of GST. If it is exclusive of GST, the purchaser as recipient will bear the landowner’s liability (as supplier) for the taxable supply. If the supply is inclusive of GST, there is no increase in the agreed price to reimburse the landowner’s GST liability.



What is not often addressed is what the parties' rights are with respect to any objections to a GST assessment or other decision of the Commissioner of Taxation (such as a party's right to be registered for GST), in circumstances where the issue which arises is contrary to either party's understanding of how GST was to be applied to the transaction.

 **Example:**

Farmer Tom proposes to sell his farm to Future Development Co Pty Ltd. Farmer Tom has intermittently carried on some form of farming activity on the land for the past 10 years. Depending on how Farmer Tom's other business activities have progressed, he has either intensively farmed the land or effectively only done so on a "hobby farm" basis.

When negotiating the sale contract, Farmer Tom informed Future Development Co Pty Ltd he has farmed the land for the past 10 years. The parties proceed on the basis that the sale will be the supply of a farm land supplied for farming in accordance with section 38-480 of the GST Act. Future Development Co Pty Ltd requires Farmer Tom to warrant in the contract that a farming business has been carried on for at least a period of 5 years proceeding the date of supply, to reflect the requirement in section 38-480(A) of the GST Act. The contract provides that if for any reason the sale does not qualify as a supply under section 38-480, Future Development Co Pty Ltd will indemnify Farmer Tom for any GST liability on the sale.

Six months after settlement, the Commissioner of Taxation informs Farmer Tom that the sale did not satisfy section 38-480 of the GST Act, on the basis that they did not consider that he had carried on a farming business on the land for a period of 5 years preceding the supply.

Farmer Tom informs Future Development Co Pty Ltd of the Commissioner of Taxation's demand for GST, and requests payment of the GST amount. Farmer Tom provides Future Development Co Pty Ltd with a tax invoice. Although Future Development Co Pty Ltd does not have the funds readily available to pay the GST liability, and is concerned about flow on effects of an assessment of the taxable supply (such as increased duty liability), Future Development Co Pty Ltd has no right to object to the Commissioner of Taxation's determination.

**"You" must be dissatisfied**

 **Legislation:**

Section 105-40(1) of schedule 1 to the Taxation Administration Act 1958 (**TAA**) provides that you may object, in the matter set out in part IVC, against a decision you are dissatisfied with that is a reviewable indirect tax decision relating to you. Section 110-50 of schedule 1 to the TAA sets out a list of "reviewable GST decisions" which includes things such as registering or refusing to register "you" and cancelling or refusing to cancel "your" registration.

Section 105-40(2) of schedule 1 to the TAA provides that a reviewable tax decision includes an assessment of an amount of indirect tax.

Section 995-1(1) of the Income Tax Assessment Act 1997 provides that GST is an indirect tax.

Critically, only "you" may object against this decision if "you" are dissatisfied with a reviewable GST decision "relating to you".

In the case of a reviewable indirect tax decision, "you" is the entity liable for GST on a taxable supply (the supplier) and, separately, "you" is also the entity entitled to input tax credits (the recipient). However, the recipient has no power to object to a reviewable indirect tax decision relating to the supplier, and vice versa. Accordingly, another person is not a dissatisfied person.



While indirectly affected by the decision, that other person is not “you” for the purposes of the reviewable indirect tax decision.

A number of cases have demonstrated the problem that may arise where one party’s conduct has a GST consequence for the other party where that other party had no right to object to those consequences:

- *Empire Securities Pty Ltd v Mioceovich and Anor*<sup>1</sup> – by the contract of sale the price was inclusive of “any GST liability of the vendor”. At the day of sale, the vendor was registered for GST. Between the contract date and settlement, the vendor sought to cancel its GST registration. At settlement, the purchaser sought a tax invoice from the vendor, but on the basis that the vendor was not registered at the date of settlement, he contended that there was no GST payable and therefore a tax invoice was not required to be provided. The purchaser had no standing to dispute cancellation of the vendor’s registration for GST or to register the vendor for GST.
- *Charmers and the Linton Charmers Superannuation Fund and Commissioner of Taxation*<sup>2</sup> – the purchaser and vendor entered into a contract for a property which included a special condition which stated that “unless otherwise expressly agreed in the contract, the seller must not apply the margin scheme on the purchase price”. The contract was entered into prior to the amendments to the A New Tax System (Goods and Services Tax) Act 1999 (**GST Act**) on 29 June 2005 requiring the parties to agree in writing to apply the margin scheme to a sale of property. Contrary to the special condition, the vendor elected to apply the margin scheme to calculate the GST on the supply of the property. The purchaser was not aware that the vendor had done so, and claimed an input tax credit in respect of its purchase of the property (despite not holding a tax invoice in relation to that supply). The purchaser was denied the input tax credit, and in fact an administrative penalty of 25% of the shortfall GST amount was imposed on the basis that the purchaser’s claim for an input tax credit was false or misleading. The purchaser had no right or ability to deal with the Commissioner of Taxation with respect to the actual election to apply the margin scheme and any request to the Commissioner of Taxation to exercise a discretion to withdraw that election.

In each of these cases, the purchaser (recipient) had no standing to make any objection against a decision of the Commissioner of Taxation which related to the vendor (supplier).

In relation to GST and property, many of the rights of a purchaser and potential liabilities are determined by reference to the conduct of the vendor (supplier). For example:

- the exemption for farmland supplied for farming in section 38-480(a) requires a farming business to have been carried on for at least a period of 5 years proceeding the supply of the land; and
- a recipient’s ability to make a “creditable acquisition”, which is defined in section 11-5 to include a requirement that the supply of the land was in fact a taxable supply, which in turn is to a degree based upon whether the supplier is registered for GST, the supply is in the course of an enterprise, etc.

Conversely, there are also various provisions which require a vendor (supplier) to rely on the conduct of a purchaser (recipient) in order to activate various provisions under the GST Act. For example, the requirement in section 38-325(1)(b) that the recipient is registered or required to be registered for GST as one of the components of a supply of a going concern.

The consequences of a recipient failing to do (or not do) what is contemplated by the parties in their agreement and negotiations can in some cases be even more serious for a vendor (supplier) when it is considered that ultimately any GST impost is the liability of the vendor (supplier). Any right to be indemnified by the purchaser (recipient) may be relied upon, but ultimately the source of liability rests with the vendor (supplier).

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<sup>1</sup> [2004] WASC118.

<sup>2</sup> AATA 308.



In some cases, the decision which may have significant consequences for the parties is not one which is voluntarily made by either party. An example of this is registration for GST, where the Commissioner of Taxation may register an entity for GST even though the entity has not applied for registration, where the Commissioner is satisfied that the entity is required to be registered<sup>3</sup>. The Commissioner has a corresponding power with respect to cancellation of registration<sup>4</sup>.

### **Are warranties, contractual rights and obligations good enough?**

It is common for development property agreements to include extensive rights and obligations with respect to the parties conduct for GST purposes.

For instance, contracts may include provisions which allow for or require:

- Where the supply is of a going concern, that the purchaser (recipient) will be registered or required to be registered at all material times.
- Where the sale is the supply of farmland used for farming, the vendor (supplier) warrants that a farming business has been carried on on the property for a period of no less than 5 years preceding the supply, and the purchaser (recipient) warrants that it intends to carry on a farming business on the property.
- Where it is proposed to apply the margin scheme to calculate GST, the vendor (supplier) may warrant that the supply is not ineligible for the margin scheme.
- Where the vendor considers that it is not registered or required to be registered for GST, the contract may include a warranty by the vendor that it is not registered or required to be registered for GST, and an obligation on the vendor not to voluntarily register for GST.

The inclusion of such warranties, rights and obligations on the parties are critical. The aim in providing such warranties must always be to ensure that the circumstances in which the warranties have been breached (and a collateral indemnity activated) can be readily ascertained in a timely manner.

Such clauses are often referred to as “tax indemnity clauses”.

However, the commercial reality is that the value of any such right is limited by the warranting party’s willingness or ability to pay on any indemnity or claim with respect to any breach if that situation arises.

### **Warranties, rights and obligations – plus the right to be “you”?**

A party entering into a development property agreement must have both a contractual right to take action against the other party with respect to their failure to satisfy their contractual obligations or warranties, together with the ability to address the direct source of liability (that is, the ability to object or otherwise deal with the Commissioner of Taxation).

Any right of party to “stand in the shoes of” the other party with respect to a GST liability and take responsibility for conducting GST proceedings must be carefully considered. Often, the parties’ interests will be aligned and it will be in both of their interests to take a particular position. For instance, in the example included in 2.1 above, it is in fact in both parties’ interests to object to the Commissioner’s position.

However, in some cases, the parties may in fact have competing interests in making (or not making) an objection or taking another position. Any provision in a development property agreement should attempt to resolve those interests, although in some cases it will be very difficult to do so. Commercially, it may be appropriate that the party with the ultimate liability for GST to be entitled to have conduct of any proceedings.

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<sup>3</sup> Section 25-5(2) GST Act.

<sup>4</sup> Section 25-55(2) GST Act.



Where it is proposed that one party will effectively take responsibility for conducting GST proceedings (which may include the conduct of an audit or proceedings, whether arising prior to or post-completion of a transaction), issues must be addressed including:

- Which party will have the conduct of any objection or dispute?
- Who will have the right to agree to compromise or settle any dispute?
- The relevant party which may have the direct liability or right to deal with the Commissioner of Taxation authorising the other party to do so.
- The provision of information received from the Commissioner of Taxation to the other party concerned.
- The provision of information by the party with the direct tax liability to the other party with responsibility for the tax proceedings.
- Who will bear the costs of any objections and dealings with the Commissioner of Taxation?

The case of *Kiwi Munchies Pty Ltd v Mikolits*<sup>5</sup> is an example of the difficulties which may be encountered in interpreting a tax indemnity clause. In that case, a lease included a provision effectively providing that the tenant would be liable for any GST on monies paid to the landlord under the lease. The landlord passed a GST liability onto the tenant, notwithstanding the fact that the landlord was not in fact registered for GST. The tenant claimed input tax credits with respect to the supposed GST liability, but on the basis that the supply of the leased premises was not in fact a taxable supply, it would be open for the Commission of Taxation to deny the tenant an input tax credit on the basis that as the supply was not a taxable supply, the tenant had not made a creditable acquisition<sup>6</sup>. If that was the case, although the tenant may have a claim against the landlord, it would have no right to compel the landlord to register for GST.

If the tenant had had a right in the lease to stand in the shoes of the landlord, the tenant may have had the ability to voluntarily register the landlord for GST, despite the fact that in this case the landlord was not required to be registered for GST<sup>7</sup>.

Difficulties in the way that the courts interpret taxation indemnity provisions can be seen in the decision of *CBA Investments Limited v Norman Star Limited*<sup>8</sup>. In this case, the terms of a long term commercial lease included a provision that “if for any reason whatsoever the Commissioner of Taxation [did] not accept” that a certain type of payment under the lease was of a capital nature, the landlord would indemnify the tenant. The receipt was ultimately characterised as being on revenue account, and the landlord accounted for the receipt on that basis. The tenant commenced proceedings against the landlord on the basis that it had not complied with the terms of the lease by objecting to the characterisation of the receipt and maintaining that the receipt was on capital account. Ultimately, the Court concluded that in circumstances such as those that presented themselves in this case, namely that any claim that the receipt was on capital account would have been a “nonsense”, the tax indemnity provision was intended to achieve a substantial outcome which was not possible in this case. The Court determined that “there was no obligation... to engage in a meaningless exercise”.

## 2.2 GST – development land and going concerns

The supply of a development property may qualify as the supply of a going concern for the purposes of section 38-325 of the GST Act.

<sup>5</sup> [2006] VCAT 929.

<sup>6</sup> See sections 11-5 and 11-20 of the GST Act.

<sup>7</sup> Section 23-10 of the GST Act provides that you may be registered for GST if you are carrying on an enterprise, whether or not you are in fact required to be registered.

<sup>8</sup> [2002] NSWCA 94.



 **Legislation:**

The “usual” going concern requirements in section 38-325(1) must be satisfied:

- the supply is for consideration;
- the recipient (purchaser) must be registered or required to be registered for GST; and
- the recipient and the supplier (vendor) have agreed in writing that the supply is of a going concern.

A “supply of a going concern” is required by Section 38-325(2) to be a supply under an agreement which:

- the supplier supplies to the recipient all of the things that are necessary for the continued operation of an enterprise; and
- the supplier carries on or will carry on, the enterprise until the day of supply (whether or not as part of a larger enterprise carried on by the supplier).

For the purposes of this paper the requirements of Section 38-325(1) are assumed to be satisfied. That is, that the supplier is in fact conducting an enterprise and is required to be registered for GST, otherwise the issue of whether the supply is the supply of a going concern may generally be irrelevant for these purposes.

The critical issue, which is the focus for this paper, is how the parties discharge the obligation for the supplier to supply to the recipient “all of the things that are necessary for the continued operation of an enterprise” of property development from the property.

Goods and Services Tax Ruling 2005/5 (**GSTR 2005/5**) provides the Commissioner of Taxation’s views in relation to circumstances where a supply development property may qualify as the supply of a going concern.

The relevant issues which arise in GSTR 2005/5 include:

- Not only constructed premises can satisfy the requirements. It is possible to supply a thing necessary for the continued operation of an enterprise in relation to substantially or partially completed premises (such as an apartment building), substantially or partially completed lots (such as a broadacre subdivision) or even land that is merely held for development<sup>9</sup>. The latter category implies that the development of the land itself is not necessarily required to have commenced.
- What is actually required to be supplied? It is not sufficient to simply supply the land, with nothing more<sup>10</sup>. The supplier must supply all the things, which obviously include the land for the continuation of the property development enterprise on the property. Although it would be necessary to consider the particular circumstances for any supply, the types of things which should expressly be provided for in the development property agreement as being supplied include:
  - the land itself – that is, ownership of the land;
  - all planning permits and other approvals associated with the development of the land (noting that although some of these approvals may relate to the land itself and therefore do not require the express transfer or assignment to a purchaser, some of the interests associated with those approvals such as the preparation of plans where ownership rests with the vendor, should be expressly and separately transferred);
  - any existing agreements in relation to future sale or leasing of the land, such as existing off the plan contracts or agreements for lease;

<sup>9</sup> GSTR 2005/5 paragraphs 19 and 27.

<sup>10</sup> GSTR 2005/5 paragraph 20.



- building permits, particularly where these building permits specifically name the vendor as the party to whom they have been issued; and
- existing construction, contractor and supply agreements (such as any building contracts for improvements being instructed on the land).

It is not sufficient simply for the parties to rely on the terms of the development property agreement which provide for these transfers – but the parties must in fact undertake a supply of those rights.

It may not be sufficient simply for the supplier to transfer its interests (to the extent it can) in those rights to the recipient. Section 38-325(2)(a) requires the supplier to supply to the recipient “all of the things that are necessary for the continued operation of an enterprise”, regardless of the source of those rights or obligations.

In relation to those rights which are effectively limited to the supplier’s interest to those rights (such as the land itself or the supplier’s interest in a development approval), it may be sufficient for the development property agreement to effect an assignment of those development rights at the day of supply pursuant to a properly drafted provision in the contract itself. However, in relation to those development rights which are derived from an agreement between the supplier and another party (such as building contracts), it would be necessary for the supplier to procure an assignment of its rights and (to the extent possible) its obligation to the third party in favour of the recipient. Practically, this may require a deed to be entered into between the supplier, the recipient and a third party expressly assigning such rights and obligations to the recipient. In doing so, any assignment provisions of the agreement with those third parties needs to be considered.

#### **What are some of the benefits of supplying development land as a going concern?**

Two of the benefits of supplying development land of going concern are:

- The dutiable value of the property for the purposes of assessing duty is not discounted for the amount of GST (if any) payable on the supply of the property<sup>11</sup>. Accordingly, the ability of development property to be sold as a supply of a going concern can result in a significant reduction for a purchaser on account of the duty liability, which in the context of the supply of a development property (assuming the margin scheme could not be applied), may result in a total cost saving of 0.55% of the value of the development property (based on duty at a rate of 5.5% assessed on the 10% GST component of a property the dutiable value of which exceeds \$960,000);
- Taking advantage of the going concern exemption will effectively allow a deferral of the GST that would otherwise be payable on the purchaser’s acquisition from the vendor, until the time that the purchaser subsequently supplies the development property (assuming that it does so in various circumstances). A consequence of the amendments to the GST Act introduced by the Tax Laws Amendments (2008 Measures number 5) Act 2005 is that when the purchaser is calculating the margin on any subsequent supply of development property, the consideration for the purchaser’s purchase is effectively the price that was paid by the original vendor when the original vendor purchased the property (or in some cases by valuation)<sup>12</sup>. Accordingly, although the use of the going concern exception no longer allows an effective uplift of the purchaser’s acquisition consideration when determining its margin on the subsequent sale of the development property if the margin scheme is used on that subsequent sale (or sales) it is still an effective mechanism for deferral of GST liability. Note that in circumstances where the subsequent sale by the purchaser is GST free (for example, as a going concern where the purchaser develops the development property into a commercially tenanted premises) or the subsequent sale (or sales) by the purchaser are on a full 10% GST exclusive basis, the use of the going concern exemption on the purchasers initial acquisition will result in a GST saving (not simply deferral).

<sup>11</sup> Section 20(2) Duties Act 2000 (Vic).

<sup>12</sup> Section 75-11(5) GST Act.



### 3 THE PUBLIC COMPANY PURCHASER

Issues may arise where a land owner is negotiating a development property agreement where the other party is a public company. In many circumstances, this will require the land owner to have an appreciation of the requirements of a public company.

In particular:

- at least in relation to significant transactions, any agreement by the public company will be required to be subject to board approval. Unless the transaction is of particular significance to the public company, it would be unusual for the board to meet for the purposes of assessing the particular agreement. Furthermore, it is unlikely that the board would assess anything but a fully executed agreement. Accordingly, a land owner must be aware of the possibility that extensive cost and time may be involved with the negotiation with the agreement, only for the agreement to ultimately not receive board approval and be terminated by the public company. A land owner should consider in those circumstances whether to demand that the agreement include an obligation on the public company to reimburse part of the cost of those negotiations to the land owner (bearing in mind the context of the agreement itself and whether any sums such as option fees and due diligence fees have already been paid by the public company purchaser).
- it is unlikely that a public company will be willing to grant a power of attorney to the land owner. There are various circumstances where a land owner may require the public company to appoint the land owner as its attorney. For example, if the development property agreement requires the land owner to register a plan of subdivision, the agreement would also normally provide that the other party would not be entitled to lodge a caveat preventing registration of the plan, and if it did so, the other party would appoint the land owner as its attorney to withdraw the caveat. Where the land owner is prevented from requiring the public company to grant a power of attorney in similar circumstances, the land owner should consider having the public company submit documents on execution of the agreement which provide the land owner with the practical tools for giving effect to the rights it would otherwise have sought to exercise under the power of attorney. In relation to the example above, the land owner would require the public company to execute a withdrawal of caveat, with the agreement between the parties specifying the bases on which the withdrawal of caveat could be used by the land owner.

### 4 THE MANAGED FUND PURCHASER

Many development property acquisitions in recent years have been made by managed funds, where the title to the land is intended to be held by a custodian or trustee for the fund.

In those circumstances, the custodian or trustee may be acting in that capacity in relation to a number of different funds. As a consequence, the custodian or trustee is generally reluctant to expose itself personally or in its capacity as custodian or trustee of those other funds to the liabilities under a development property agreement.

Custodian or trustee purchasers will generally attempt to limit their liability under the development property agreement.

 **Example:**

Farmer Jo proposes to sell his farm (which has recently been rezoned to permit residential development) to Property Development Trustees Limited as Custodian of the New Age Property Fund. The purchaser requires the following clause to be included in the contract of sale:

**1. LIMITATION OF LIABILITY**

1.1. The parties acknowledge that:



- 1.1.1. the Purchaser has entered this Contract in its capacity as custodian for XYZ Fund ("Fund") and not in its personal capacity;
  - 1.1.2. subject to special condition 1.3, the Purchaser is not liable to pay or satisfy any of its obligations under this Contract and has no liability to the Vendor, except to the extent of the Purchaser's right of indemnity out of the assets of the Fund; and
  - 1.1.3. if those assets are insufficient, the Vendor (subject to special condition 1.3), may not seek to recover any shortfall by bringing proceedings against the Purchaser personally and may not seek appointment of a liquidator, administrator, receiver or similar person to the Purchaser in any liquidation, administration or arrangement of or affecting the Purchaser.
- 1.2. Subject to special condition 1.3, the Vendor waives its rights and releases the Purchaser from any personal liability whatsoever in respect of any loss or damage which cannot be paid or satisfied out of the assets of the Fund.
- 1.3. The Purchaser is liable personally and is not released to the extent that a liability under this Contract arises out of the Purchaser's own fraud, gross negligence, breach of trust or breach of duty which disentitles it from an indemnity out of the assets of the Fund in relation to the relevant liability.
- 1.4. Notwithstanding any other provision of this Contract, the liability of the Purchaser is limited by the provisions of this special condition 1. In the event of any inconsistency with any other provisions of this Contract, this special condition is paramount.
- 1.5. Where the Purchaser, in its capacity as custodian of the Fund, appoints an agent to act on its behalf:
- 1.5.1. the agent is not the agent of the Purchaser in its personal capacity;
  - 1.5.2. the agent cannot act on behalf of the Purchaser in a way which exposes the Purchaser to any liability; and
  - 1.5.3. no act or omission of such agent will be itself considered fraud, negligence, breach of trust or breach of duty of the Purchaser.
- 1.6. The parties agree that the reference to an agent in special condition 1.5 does not include an officer or employee of the Purchaser.

Provisions such as this should cause several difficulties for the land owner. These include:

- does the limitation of liability extend as far as excluding, in appropriate circumstances, the land owner's right to forfeiture of any deposit or security paid by the fund?
- does the limitation of liability prevent the land owner making a claim for specific performance?

There is an inherent inconsistency in the application of a standard limitation of liability condition such as that above in relation to proposed action by the land owner which, instead of simply being a monetary claim against the fund, is instead an attempted assertion of a right by the land owner which requires the fund to in fact do something. This may be of particular difficulty in circumstances where the fund has, for instance, agreed to make various submissions, applications and proposals for development approvals.

The parties must reconcile these inconsistencies at the outset and exclude, where possible, such conduct as is not intended or practically capable of being the subject of such a limitation or liability. In those circumstances, it is possible that the land owner's rights with respect to any breach by the purchaser cannot be adequately satisfied by payment of compensation in the form of damages and therefore the land owner's rights against the custodian or trustee being limited to "assets" of the trust may not provide adequate remedy.



In those circumstances, it would be necessary for the land owner to specifically provide in the limitation of liability provision that the liability is only limited with respect to any damages or any other monetary claim against the trustee or custodian, and that in a sale context, any limitation of liability does not prevent forfeiture of a deposit paid.

Even in circumstances where an exclusion to the limitation of liability provision is accepted by the custodian for trustee, the land owner must be made aware that its rights with respect to any of the obligations of the custodian or trustee will be limited to that extent.

## 5 FIRST (AND LAST) RIGHTS OF REFUSAL

It is common for many development property agreements to include a first right of refusal, last right of refusal, or a first and last right of refusal. This will generally arise in non-sale contract type arrangements, because obviously in the contract context it is unnecessary for any of the parties to have a first or last right of refusal over the property the subject of the contract.

In the context where a first or last right of refusal is provided, it can sometimes be on the basis of an attitude of “what have I got to lose?”; the justification being that by its very nature, the land owner will be able to achieve a desired sale, although the party to be the purchaser may vary.

Unfortunately, a “standard form” first and last right of refusal can cause significant practical difficulties for a land owner.

### Example:

#### 1. First and last right of refusal

1.1 For a period of two years after the execution of this Deed, the Owners agree that they will not sell the Property or any part of it to a third party unless the Owner has first made a written offer to sell the Property to DeveloperCo in accordance with this clause.

1.2 The offer must be in the form of a contract signed by the Owner, and remain open for acceptance by DeveloperCo for a period of:

1.2.1 if the Owner proposes to sell the Property or any part of it by tender, 10 Business Days; or

1.2.2 in any other case, 20 Business Days,

after delivery to DeveloperCo (**Acceptance Period**).

1.3 Where the Owner proposes to sell the Property or any part of it by tender, the Owner must invite DeveloperCo to participate in the tender.

1.4 If the offer referred to in clause 1.2 is not accepted by DeveloperCo within the Acceptance Period, the Owner may, within 6 months after the offer is made under clause 1.2, accept an offer for the purchase of the Property from a third party (**Third Party Offer**), conditional on DeveloperCo's rights under this clause.

1.5 Within five business days after accepting the Third Party Offer, the Owner must offer to sell the Property to DeveloperCo for the price and on the same terms as the Third Party Offer.

1.6 The offer made by the Owner to DeveloperCo under clause 1.5 must be in the form of a contract signed by the Owner, and remain open for acceptance by DeveloperCo for a period of 20 Business Days after delivery to DeveloperCo (**Second Acceptance Period**).



1.7	If the offer is not accepted by DeveloperCo within the Second Acceptance Period, the Owner may sell the Property to a bona fide third party purchaser not related to or an associate of the Owner on the terms and conditions contained in the contract offered to DeveloperCo under clause 1.6 (but not otherwise).
1.8	The right of first refusal under this clause 1 does not apply to:
1.8.1	an assignment of the Property (or any part of it) by the Owner to a Related Entity provided that the Related Entity first executes an agreement on the same terms as this Deed; or
1.8.2	the transfer or assignment of any part of the Property to a Responsible Authority for location of infrastructure or as public open space, or by compulsory acquisition; or
1.8.3	the transfer or assignment of any part of the Property (or any part of it) to a person(s) controlled by the Owner ( <b>Controlled Person</b> ) provided that the Controlled Person first executes documents relating to that part of the Property transferred on the same terms as this Deed.

### 5.1 The duration of the right

In considering the inclusion of a first or last right of refusal in any agreement, whether the right is for a particular term (for instance, during the term of the development agreement or lease), or is effectively open ended must be considered and expressed.

### 5.2 Types of rights of refusal

Is the right to be a first right of refusal only, a last right of refusal, or a first and last right of refusal? The clause above is the first and last right of refusal. Effectively a first and last right of refusal gives the grantee “two bites of the cherry”.

A number of factors need to be considered:

- if the intent of the right is that the land owner has the opportunity to test the market, and upon receiving an offer that it is willing to accept it must put that offer to the grantee of the right, then only a last right of refusal would be appropriate.
- if the right is intended to allow the grantee an opportunity before the property is taken to the market to purchase the property on terms that (at that stage) the land owner would be willing to accept, and a first right of refusal is appropriate, whether or not coupled with a last right of refusal.

If a first right of refusal is given, it is possible that a reasonable compromise is that it is only necessary for the land owner to give the grantee of the right a further right of refusal (a last right of refusal), in circumstances where the terms of the proposed dealing with the third party are more beneficial (from the grantee’s perspective) than those initially offered to the grantee.

### 5.3 Time for acceptance and other issues

All grants of a right of refusal should allow the land owner to enter into a conditional contract or agreement for the dealing with the land, conditional upon satisfying any right of refusal which the land owner is obliged to satisfy.

Effectively, the third party will need to be aware that the land owner has the obligation to give the right of refusal.



This raises a number of issues:

- if the initial agreement in which the right of refusal has been granted contains a confidentiality provision, the land owner's obligations in relation to confidentiality must expressly exclude any disclosure which is required to satisfy its obligation in relation to the right of refusal.
- when negotiating the right of refusal, the land owner needs to consider whether, practically, a third party will be willing to make its agreement conditional upon another party (possibly a competitor) deciding whether or not to replace the third party. In doing so, the terms of the deal struck with the third party will necessarily be required to be disclosed to the grantee of the right.
- after what may have been several months of negotiation, the land owner may enter into a contract with the third party, only for the time and expense incurred by the third party to be wasted if the grantee exercises the right to purchase the property. Effectively, there is only limited expense incurred by the land owner, as the offer to be put to the grantee has effectively already been prepared.
- the third party is also obliged to sit and wait for the period of time that the grantee has to accept the offer before being able to determine absolutely whether it will have an agreement on the terms essentially agreed. In the example above, the 20 business day "Second Acceptance Period" is a 4 week period which the third party may simply be unwilling to tolerate. All contractual documents between the land owner and the third party will be required to be conditional on the grantee's decision, and any period intended to be effective from the execution of the development property agreement between the land owner and the third party (such as due diligence or FIRB approval), can only reasonably commence upon expiration of the grantee's period to exercise its right.

All in all this may provide for a practically difficult obligation for the land owner to satisfy.

#### **5.4 What should be excluded from the right of refusal?**

There are some dealings with the land by a land owner which should reasonably be excluded from the grantee's right to acquire the property. These can generally be divided into two categories:

- Those dealings where it is intended that the third party will enter into a similar obligation with a grantee (whether in relation to all of the obligations under the agreement initially with the land owner or only the right of refusal).
- Those dealings with the land where the third party will not be obliged to enter into a similar agreement with the grantee.

#### **5.5 Where the third party will enter into a similar obligation with the grantee**

Where there is an exclusion from the right of refusal in relation to transfers to entities related to the land owner, it is reasonable for the grantee to require an obligation for the transferee to enter into similar obligations with the grantee.

It is reasonable that the exclusion of the right of refusal from such transfers is on the basis that the transferee covenants by deed to enter into either the whole of the agreement with the grantee, or the right of refusal. The extent to which that will be the case will ultimately need to be negotiated.

Any exclusion for transfers to related entities should be drafted broadly enough to encompass not only related corporations, but potentially also related trusts and superannuation funds.

In excluding the right of refusal in these circumstances on the basis that that related entity covenants to be bound by those terms (or entering into a new deed on those terms), this will effectively prevent the assignment by the land owner to a related entity with the intent of avoiding the obligation to give the right of refusal.



## 5.6 Where the third party will not enter into a similar obligation with the grantee

There are some circumstances where it is not appropriate for the right of refusal to apply, but it is also not appropriate for a transferee from the land owner to be required to be bound by the obligations to the grantee.

Some of these may include:

- where the transfer relates to the completion of the activities proposed by the agreement itself, for instance, where the right of refusal is contained in a development agreement which provides for the development of the land and sale of lots, the actual sale of those lots as contemplated by the development agreement should not trigger the grantee's right of refusal.
- where the parties can reasonably contemplate that the development of land may require a transfer or assignment of part of that land to a government or municipal authority, there may not in fact be an actual ability for the land owner to make that transfer or assignment conditional on the grantee exercising a right of refusal. For instance, where the transfer or assignment to the municipal authority is in relation to a public open space requirement, location of infrastructure or compulsory acquisition, there cannot be a right for that land to be acquired by the grantee instead.

A difficult situation arises in relation to auctions and tenders. A land owner may argue that in an auction or tender situation, the grantee has a right to offer to purchase the property in the same way as any other person may tender or bid at the auction.

The counter argument for the grantee may be that (particularly in relation to a last right of refusal), they should only be required to purchase the property on terms equal to the best terms offered by a third party. Although this can essentially be achieved in an auction situation (where the grantee of the right is able to determine what a third party's best offer is), the nature of a tender is generally such that it would not be readily apparent to the grantee what that other best offer is.

There is scope for providing in the agreement between the land owner and the grantee that with respect to a tender, the land owner will put the offer to the grantee on the terms of a tender received by the land owner that would be acceptable, for the grantee to then exercise its right during the tender acceptance period. In doing so, however, the land owner must be considerate of its obligations to any tenderer in relation to confidentiality.

## 6 THE GROWTH AREAS INFRASTRUCTURE CHARGE

In December 2008 the Victorian Government released "Melbourne 2030: a planning update, Melbourne@5million" in which one issue addressed is funding infrastructure in new growth areas.

The Government's proposal is to introduce a Growth Areas Infrastructure Contribution (**GAIC**). For any land brought within the Urban Growth Boundary (**UGB**) in or after 2009, the GAIC will be calculated initially as \$95,000 per hectare, to be incurred on the first property transaction on either the sale or subdivision of the land (a lower per hectare rate of \$80,000 applies for any land brought into the UGB since 2005). The GAIC will apply from 2 December 2008 but will take effect following enactment of the legislation anticipated in 2009.

A Growth Areas Authority information sheet gives more details, including that the GAIC will not apply to property less than 0.4 hectares in area and that in addition to sale or subdivision, the GAIC liability can also be triggered by the issuing of a building permit for major building works.

### 6.1 Who should bear the GAIC liability?

It may sound obvious, but the parties need to consider and agree who among them will ultimately bear the GAIC liability.



The Planning Update and GAA information sheet indicate the legislation will impose the GAIC on the land owner. Despite this, the parties will need to determine whether the land owner will bear the liability, or pass this on to the developer/purchaser.

Where the developer/purchaser is to pay or reimburse the land owner, the land owner should require a provision that charges the land (post-settlement) with any liability of the developer/purchaser to pay or reimburse the GAIC, pursuant to which a caveat may be lodged on title.

## 6.2 When will the GAIC be payable?

If the liability is triggered by a sale, will it arise on entering into a contract or an option agreement (see below) or at settlement? If it is settlement, what happens for terms/instalment contracts where there is a preliminary and final settlement?

If the contract date is the trigger for liability, this will be particularly problematic if it is to be borne by the land owner, who is unlikely to have any sale proceeds (with the deposit unable to be released if it is a conditional contract) to pay the liability.

## 6.3 What about the subdivision trigger?

The GAA fact sheet states that in the absence of a sale prior to development of the land, the GAIC will be paid as part of the development process.

It is likely that subdivision means registration of a plan of subdivision but in reality registration is only the final part of the subdivision process. That being the case, subdivision may mean the issuing of the planning permit permitting subdivision, certification of the plan of subdivision or issuing of the statement of compliance. If it is issuing of the permit or certification of the plan, these things (particularly the issuing of the permit) can happen months or years before registration. This can have significant cash-flow consequences where registration is a precondition for a settlement.

Where the GAIC is incurred on subdivision, is it calculated on all of the land in the subdivision?

### Example:

Farmer Jane agrees to sell lot 1 to DeveloperCo Pty Ltd subject to registration of a plan of subdivision, with Jane to keep the balance of the land.

Will the GAIC be calculated on the whole of the land or just the part sold to DeveloperCo Pty Ltd?

There may be some circumstances where a plan of subdivision is registered with no intention of immediate sale or development of the property – for instance for personal or family reasons. In some cases properties may be transferred to related entities for little or no consideration. In those circumstances, will payment of the GAIC be deferred until the next sale of the property to a third party? Will interest accrue in the meantime?

## 6.4 Will an option agreement trigger the GAIC?

Will the granting of an option be deemed to be the first property transaction of the land? In some legislation (for example the Sale of Land Act 1962), the definition of contract of sale includes the granting of an option.

Again, in these circumstances if the land owner will bear the GAIC, they are unlikely to have any sale proceeds – although they may have an option fee – to pay the GAIC. If the GAIC is to be the purchaser/developer's liability, they may not be fully committed to the land yet but be required to pay the GAIC.



## 6.5 What if the contract was entered into before December 2008?

The legislation is expected to include transitional provisions that may help the parties in transactions which were finalised before 2 December 2008 – but what will be required to have been agreed before then?

The GAA information sheet confirms that a totally binding sale arrangement can take advantage of the transitional provisions, but the nature of transactions for proposed development land is such that although binding, the arrangement may remain conditional on several bases, some of which are discretionary and subjective. It is unclear whether such arrangements would qualify.

If the parties had entered into an option agreement – but not a contract itself – will that be enough? What if the option did not specify a sale price, but only a mechanism involving valuation of the land? Does it make a difference if it is a put and call option, or just a put option or call option?

At one extreme, it is unlikely that any non-binding agreement between parties would enable them to take advantage of the transitional provisions. At the other extreme, if an unconditional contract had been entered into before 2 December 2008 the transitional provisions are likely to apply.

Importantly, the transitional provisions will not make the land itself exempt from the GAIC, only the transaction. That is, the GAIC will be incurred on the next dealing with the land. In that case, if an exempt contract has as a condition subdivision of the land, will the subdivision be exempt also or will it trigger the GAIC? This is unknown.

## 6.6 How to address these uncertainties

Parties to development property agreements must consider:

- who will (contractually) bear the liability, regardless of where the legislation imposes it?
- if the transaction involves a subdivision, who controls the process to ensure that any GAIC liability is managed?
- is entering into an option agreement more appropriate than a conditional contract, particularly if entering into the contract is the GAIC trigger but an option may not be?
- when the liability may arise. If the land owner is paying the GAIC, what if the liability arises before settlement? Will the developer/purchaser fund the GAIC and deduct an equivalent sum (plus interest) at settlement?

Parties should not rely on any relief from the transitional provisions in the enacting legislation.

## 7 CONTROL OF THE DEVELOPMENT PROCESS

Generally, a developer will want to retain control of the development process. This can extend from applications for various approvals (such as rezoning, subdivision or use), to any construction required, marketing and sales.

Where the developer is not the owner of the land, consideration must be given to the role that the land owner will play. In certain circumstances, it will be in the land owner's best interest to take a passive role in the development, whereas in others the land owner will desire constant input and decision making power.



## 7.1 The passive land owner

There can be a number of reasons why a land owner will want to take a passive role in the development of a property, such as:

- the terms of the arrangement proposed by the developer may be of such commercial benefit of the land owner that the land owner's passive position is effectively "bought" by the developer.
- where the land owner acknowledges its inability or unwillingness to be involved in the development process and that it cannot add any value to the development process.
- where other circumstances relating to the land owner do not allow it to actively participate in the development. This can particularly be the case where the land owner's activity in the development and sale of the land is intended by the land owner to be the mere realisation by the land owner of a capital asset<sup>13</sup>.

In circumstances where the parties intend that the land owner takes a passive role, the agreement between the parties must impose, at a minimum, an obligation for the passive land owner to do all things necessary to assist the developer to achieve the tasks intended to be carried out by the developer (whether that relates to a particular type of development, subdivision of the land etc).

This will also require, in the appropriate circumstances, the passive land owner to grant a power of attorney to the developer as well as control, access and use of the development property (see below).

## 7.2 The meddling land owner

In some circumstances, a land owner may require continuous involvement in the development process.

This may be on the basis that the land owner has to that point already been involved in the development process, but more usually this will arise where the financial outcome of the development impacts on the return to the land owner.

In these circumstances, the land owner must determine which decisions in relation to the development are critical and, as such, that the land owner must have involvement in the decision making process.

These may include:

- where the agreement between the parties specifies a type of development, any change to that type of development.
- in relation to a broadacre subdivision, a minimum or maximum number of lots which must be included within the subdivision.
- where it is proposed that the land will at some point in the development be sold, a minimum value for which the land (or parts of it) can be sold, or a method of involvement in the determination of those prices.
- where any part of the development activities to be financed, the identity and terms on which financing is to be obtained.
- where the development requires construction of improvements on the land, the identity of the builder.

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<sup>13</sup> See for example in relation to income tax and CGT, Jorgensen, Ronald, "Property Development – some selected tax issues" (2003) (presented at the Taxation Institute of Australia Tasmanian State Convention, 17 August 2003) and in relation to various GST issues, see Miscellaneous Tax Ruling MT2006/1 "The New Tax System: The meaning of entity carrying on an enterprise for the purposes of entitlement to an Australian Business Number".



This list is not by any means exhaustive and in addition to any specific items to be addressed, the agreement should include a comprehensive management and board structure which includes the land owner, together with a detailed procedure for breaking any decision deadlock between the land owner and developer.

### 7.3 Control, access and use

The nature of the development property will dictate the extent to which the developer may have control, access and use of the property for various purposes.

Issues may arise including:

- if the property is used for activities which qualify as primary production activities under the Land Tax Act 2005, it will be beneficial for those activities to continue for as long as possible. Accordingly, in circumstances where a broadacre subdivision is taking place, only those parts of the land necessary to conduct the construction of the development should be used and the remainder should continue to be used for those primary production activities for as long as possible.
- any use of the development property must be subject to any existing rights of tenant in occupation.
- in a sale context, a land owner should be careful to ensure that any access or use of the land given to a developer purchaser does not constitute the giving of possession for the purposes of the Sale of Land Act 1962<sup>14</sup>.

## 8 CONCLUSION

The issues set out in this paper will be relevant for many development property agreements.

It is likely that in each specific situation, there will be issues arising which are particular to the terms of the negotiation or the land itself. Accordingly, although no two development property agreements will be the same, however, the issues dealt with in this paper should be considered in almost every case.

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<sup>14</sup> Section 29A(1)(b), but see section 29F(3).