

Indirect tax issues affecting cash flow in the real estate sector

The pandemic and near shutdown of local, national and global economies have presented cash flow challenges for businesses across sectors. This white paper provides an overview of several goods and services tax and harmonized sales tax (GST/HST) and Quebec sales tax (QST) issues that affect the cash flow of businesses in the real estate sector, including construction companies, developers of commercial and residential properties for sale, as well as owners and managers of commercial and residential rental properties. We also discuss particular opportunities in this sector relating to public service bodies, including charities and nonprofit organisations.

Purchases by real estate businesses engaged in taxable activities

Overview

The development, sale and lease of commercial properties (e.g., office buildings, manufacturing premises, warehouses, retail establishments and hotels) as well as the construction and sale of new homes, are generally taxable activities (also referred to as “commercial activities”) for goods and services taxes and harmonized sales tax and Quebec sales tax purposes. As a result, GST/HST and QST registrants may recover GST/HST by way of input tax credit (ITC) and QST by way of input tax refund (ITR) on related costs. The following describe how these businesses may reduce GST/HST and QST related costs.

Taxable purchase of land and buildings by registered purchasers for use in commercial activities

A vendor is generally not required to charge, collect and remit GST/HST or QST on a sale of taxable real property to a registered person (not including sales of residential complexes such as new homes to individuals). Rather, the registered purchaser should self-assess the tax in the purchaser’s return for the reporting period in which the property was acquired and claim an off-setting ITC or ITR in the same return, thus negating any cash flow cost for the purchaser of paying the GST/HST and QST to the vendor and then claiming a credit.

Although our focus is on savings opportunities for the purchaser in this case, the vendor should exercise care in confirming the purchaser’s registration status¹ and documenting representations from the purchaser that the

purchaser is not acting as an agent of another person and that the purchaser will self-assess the tax. It may also be appropriate to obtain an indemnity provision for the tax and any applicable penalty and interest should the vendor be assessed as a result of a misrepresentation by the purchaser.

Maximize ITCs and ITRs

A new business entity should register as soon as possible at the commencement of a commercial activity. Also, the new registrant should ensure processes are in place to identify, capture and claim ITCs and ITRs for GST/HST and QST, respectively, on all costs relating to its commercial activities, including costs that may not be accounted for in the regular accounts payable system (e.g., direct automatic payments from bank accounts, payments through payroll, etc.).

It may be appropriate to choose a more frequent GST/HST or QST filing frequency (e.g., monthly versus quarterly or yearly) to accelerate the recovery of GST/HST and QST on taxable costs, particularly during the development phase of a project, when tax payable on costs exceeds tax collectible on sales or leases.

A review of past AP data and supporting documentation by your indirect tax advisor can identify recoveries of tax due to missed ITCs and ITRs and other errors resulting in significant recoveries and recommendations for process improvements to identify and capture recoveries going forward.

Timing significant purchases or imports of equipment and supplies

Where possible, consider the timing of a significant purchase or importation of equipment or supplies to save cash flow costs relating to the payment and recovery of the applicable tax. The GST/HST and QST may be claimed as an ITC or ITR respectively when the tax becomes payable or is paid without having become payable. For example, if a major taxable purchase is invoiced to a GST/HST-registered monthly filer on May 30, 2020, under terms not requiring payment to the vendor for 30 days, and the GST/HST payable results in a credit return for the May reporting period, the purchaser should file the May return as soon as possible in June 2020. It is possible that the CRA will issue the refund for the May return before the purchaser is required to pay the vendor.

Use of elections

Various elections are available to streamline GST/HST and QST accounting and reduce cash flow costs. These elections include the joint venture election for simplified GST/HST and

¹ A purchase’s GST/HST registration number can be verified by accessing the CRA’s GST/HST web registry or by contacting the CRA via phone

QST accounting, the election to relieve GST/HST and QST on the sale/purchase of a business, and elections to relieve the GST/HST and QST on transactions between closely related parties. The joint venture election is discussed below. Also, more detailed discussions of these elections will be included in future articles.

Bad debts

Regrettably, as the economic fallout from the pandemic continues, there will be an increase in bad debts on commercial leases. Lessors that reported GST/HST and QST on lease payments that became due but were not paid by their tenants are generally eligible to recover the GST/HST and QST, when the bad debt is recognised. When making these claims, it is essential to ensure that sufficient evidence is maintained to support your claim that the debt is in fact uncollectable in accordance with the CRA's or Revenue Quebec's policy.

Purchases by developers and owners of residential rental properties

Overview

In general, residential long-term rentals,² including apartments and senior housing, are exempt from GST/HST and QST; as a result, tax does not apply to the rental charge by the landlord to tenants, but there is no recovery by way of ITC or ITR for the tax on costs to operate the property.

However, special rules, generally referred to as the "self-supply" rules, apply to residential rental construction, substantial renovations, additions and conversions. These rules require the developer/owner, generally referred to as the "builder,"³ to register for the GST/HST and QST. The builder is eligible to claim ITCs or ITRs for the GST/HST or QST, respectively, incurred on the acquisition of the property and construction costs, but is required to remit the GST/HST or QST on the fair market value of the property⁴ at the later of the time of substantial completion or first occupancy by a tenant (i.e., at the time of the self-supply).⁵

A new residential rental property rebate may be available to the builder (i.e., the landlord rebate) to recover a portion of the GST/HST and QST imposed on the self-supply. Otherwise, the GST/HST and QST on the fair market value of the property at the time of the self-supply and on ongoing costs of operation of the residential rental property are not recoverable.

These self-supply and landlord rebate rules can be complicated to apply in practise and GST/HST and QST returns reporting significant recoveries during the early phases of development and a significant remittance at the time of the self-supply, net of the landlord rebate, will almost certainly be subject to review by the CRA or Revenue Quebec.

Maximize ITCs and ITRs during the development phase

The general approaches to maximizing ITCs and ITRs described above for purchases by businesses engaged in the development of commercial properties also typically apply to builders of residential rental properties during the development and construction phase (i.e., prior to the self-supply).

In addition, a builder of a new residential rental property, or one engaged in substantial renovation, addition or conversion, should pay particular attention to the timing of taxable costs that arise during the final stages of construction, in particular, taxable costs that straddle the time when the obligation to pay the tax on the fair market value of the property arises. In the case of an apartment building, the tax in respect of the entire building is required to be remitted by the builder under the self-supply rules at the later of the time the first tenant takes possession of a unit and substantial completion of the building (i.e., when 90% or more of the construction of the complex is at a stage of completion). ITCs or ITRs for the GST/HST and QST, respectively, should be claimable on construction costs that accrue prior to the self-supply date (and form part of the fair market value of the property) but may be paid subsequent to that date.

Rental apartment buildings vs. rental condominiums

It is important to distinguish between the timing of the self-supply and the impact on ITC and ITR claims for typical apartment buildings on one hand and condominiums on the other. In the case of apartment buildings, the self-supply rules apply on the entire property at the later of the time the first tenant takes possession of a unit and substantial completion of the building. In the case of condominiums for rental purposes, the self-supply rules apply on a unit-by-unit basis, as individual condominiums are occupied or substantially completed.

Minimize GST/HST and QST on the valuation at substantial completion

A significant GST/HST or QST liability will arise when the self-supply obligation arises on newly constructed residential property; at the later of the time of substantial completion or when the first tenant takes possession of a unit as a place of residence. The rules should be applied to reduce the potential for overpayments by the landlord of this unrecoverable tax.

The appropriate valuation methodology should take into account that in the GST/HST and QST context the fair market value of the property, not the value of the business as a going concern, is to be determined. The latter view can overstate the value for tax purposes. Also, the value is to be determined at a particular point in time for GST/HST and QST purposes. It is possible that only 90% of the construction, renovation or conversion of the building will have been completed when the self-supply obligation arises. This will affect the valuation for GST/HST and QST application purposes.

² Generally if the term of the rental is for more than a month.

³ "Builder" is a defined term in the GST/HST and QST legislation. In general, a builder has an interest in the property and undertakes construction, substantial renovations or additions to the residential property. A construction company that does not have an interest in the property is not a builder; but may be engaged by the builder.

⁴ There are variations on and exceptions to the self-supply rules for certain kinds of housing, such as subsidized or nonprofit housing and student residences.

⁵ The purpose of these rules is to put the builder in the same GST/HST or QST position as if the builder had purchased the newly constructed building and related land from a third party and paid the applicable GST/HST or QST at the time of purchase and was not able to recover the GST/HST and QST paid.

In addition, under the cost method, specific costs should be excluded that might otherwise be included in a valuation for purposes other than the GST/HST or QST self-supply rules (e.g., excess land and commercial portions of the property). Also, other costs such as furniture and fixtures that do not form part of the property should be excluded from the valuation.

It is recommended that the builder work with an independent appraiser who is well versed in the GST/HST and QST considerations that will affect the appraisal approach. An indirect tax advisor with experience in this area should be involved in discussions with the appraiser to ensure that these GST/HST and QST considerations are taken into account. Your advisor can also review past appraisals to determine if recoveries of overpayments of tax are possible.

New residential rental property rebate

The landlord rebate (NRRP rebate or landlord rebate)⁶ for new residential rental property may be available to a landlord who purchases a new residential rental complex from a builder and pays the applicable GST/HST or QST or is the builder of the complex or an addition to the complex and was subject to the self-supply rules discussed above.⁷

Unlike the new housing rebate, the landlord rebate is not assignable to the builder/vendor of the property. As a result, the landlord must be aware of the landlord's eligibility and file the necessary forms with the CRA or Revenue Quebec.

It is important to maximize the landlord's rebate claim, while taking into account potential compliance traps (e.g., primary place of residence test, generally for one-year of continuous occupancy, etc.).

Third-party management and administrative services

In some cases, an opportunity may exist to minimize the GST/HST and QST payable on management and administrative services supplied by unrelated third parties to property owners. For example, in the case of owners/operators of long-term care homes, it may be possible to acquire certain health care and personal care services on an exempt basis. Also, it may be possible to structure the flow-through of certain nontaxable labour costs (e.g., through agency and cost-sharing) so that otherwise unrecoverable GST/HST and QST incurred by the owner/operator of the homes is reduced. We recommend you speak to your indirect tax advisor to review if such costs can be minimized in your situation.

Special considerations for public service bodies

Overview

Public service bodies (PSBs) include nonprofit organizations, charities, municipalities, school authorities, public hospitals, public colleges and universities. Special GST/HST and QST rules apply to these organisations. The following are some approaches specific to PSBs that may increase recoveries and

reduce cash flow costs relating to GST/HST and QST incurred in these organisations' real estate activities.

Election to treat sales and leases of real property as taxable

Subject to certain exceptions, generally sales and leases of real property by PSBs (excluding financial institutions, municipalities and governments) are exempt from GST/HST and QST. As a result, the PSB is not entitled to recover by way of ITC or ITR the tax paid on related costs; however, the PSB may be entitled to partial recovery of tax paid by way of a PSB rebate.

Also, with respect to purchases of capital real property, ITCs and ITRs can be claimed if the property is intended to be used primarily (i.e., more than 50%) in commercial activities. ITCs and ITRs are not allowed if the property is not intended for use primarily in commercial activities.

A PSB may consider filing a section 211 election and its QST equivalent⁸ to treat real property sales and leases as taxable for GST/HST and QST recovery purposes. For example, if a long-term commercial lease of a building or portion of the building becomes taxable, this enables the PSB to claim ITCs for GST/HST paid on costs of acquiring and maintaining the building or the portion of the building that is leased to commercial tenants. If the tenant is a business engaged in commercial activities, the tenant should be indifferent to the tax being charged because it would also be able to recover the GST/HST on the lease payments.

Also, a section 211 election or its QST equivalent supersedes the primary test for ITCs and ITRs on capital real property. A PSB's ITC and ITR eligibility will be based on the percentage of the property's use in commercial activities. If commercial use of a building is more than 10% but less than 90% in commercial activities, the PSB will be entitled to claim ITCs and ITRs based on that percentage of use of the property in commercial activities. If the use in commercial activities is 10% or less, the PSB cannot claim ITCs or ITRs. If the use in commercial activities is 90% or more, the PSB is entitled to 100% ITCs and ITRs. Therefore, the main opportunity for PSBs in this case of mixed-use capital real properties is if the use of the property in commercial activities is between 10% and 50%. It is also noteworthy that ITCs and ITRs based on the percentage of use will apply under the change of use rules, potentially resulting in a recapture of tax previously paid on the real property, based on the basic tax content of the property.

Change of use

The use of real property may change over the years. Under the general rules for PSBs, if a building that was used more than 50% in the PSB's exempt activities is now used primarily in commercial activities, the PSB may claim ITCs or ITRs. On the other hand, if a building that was used more than 50% in the PSB's commercial activities is now used primarily in exempt activities, the PSB may have to reimburse the ITCs or ITRs that were claimed earlier.

Municipal designations

An organisation, including a charity or nonprofit organisation,

⁶ The NRRP rebate is not available to organisations eligible for the public sector body rebate, such as registered charities.

⁷ Other special rebates are available to owners of land leased for residential purposes and co-operative housing.

⁸ Election under section 272 of the Act respecting the Quebec sales tax

may be designated as a municipality for its supplies of long-term residential rent-geared-to-income (RGI) housing, for purposes of claiming the 100% municipal PSB rebate for the GST and the federal portion of the HST paid or payable in respect of this designated activity. They may also be entitled to claim a rebate of the provincial part of the HST and a portion of the QST in Quebec. These designations can significantly increase the PSB's recovery of GST/HST and QST on costs incurred to provide RGI housing. In certain circumstances these designations may have retroactive effect.

Maximize PSB rebates and exempt purchases

PSBs engaged in exempt activities, should ensure that they maximize their PSB rebate claims on related costs. For example, registered charities and qualifying nonprofit organisations that operate long-term care homes may be entitled to increased PSB rebates (e.g., in Ontario, claim 83% of the federal component of the HST and 87% of the provincial component; rather than the general registered charity rates of 50%/82%).

The self-supply rules discussed above relating to new residential rental construction, substantial renovations, additions and conversions generally apply to PSBs. It is important to note, however, that PSBs entitled to the PSB rebates should claim the PSB rebates, and not the landlord rebates, for the GST/HST or QST remitted at the time of the self-supply. The PSB rebates should result in increased recoveries.

Finally, certain services supplied to operators of seniors' homes are exempt; operators could be overpaying GST/HST and QST on purchases of these services from third parties (e.g., nursing and dietetic services, homecare services, etc.).

Special organisational structures and mixed-use properties

Overview

This section discusses particular issues relating to certain organisational structures and special circumstances involving both commercial and residential properties.

Co-ownerships and joint ventures

Co-ownerships, including joint ventures, are not "persons" for GST/HST and QST purposes. Under the general rules, each co-owner or participant in a joint venture would have to register and account for the owner's/participant's proportionate share of the GST/HST and QST on transactions relating to the venture's commercial activities. An election, referred to as the "joint venture election," simplifies GST/HST and QST accounting by permitting a designated registered person (i.e., the operator) to account for the GST/HST and QST on purchases and supplies made by the venture. Also, once in place, the election generally relieves GST/HST and QST on the operator's services supplied to other members of the joint venture. As a result, the election can simplify GST/HST and QST accounting as well as reduce cash flow cost for participants in the venture.

However, there are significant complex qualifying criteria and supporting documentation requirements as well as exceptions that must be considered. These considerations will be discussed in detail in a future article. If you are considering this structure please discuss the possible application of the election in your circumstances with your indirect tax advisor.

Special rules for real estate investment trusts

REITs are considered financial institutions for GST/HST and QST purposes. Special GST/HST and QST accounting rules apply to REITs. Furthermore, certain REITs have additional GST/HST and QST filing obligations that are specific to financial institutions. We recommend that structures involving REITs should be reviewed by an indirect tax professional as this is an evolving area for GST/HST policy and administration.

Intercompany supplies

Depending on your circumstances, there may be approaches to reduce otherwise unrecoverable tax on intercompany charges between related members of a group of organisations, such as GST/HST and QST on fees for management and administrative services. These approaches may include the use of cost sharing/agency agreements, the transfer of employees to an exempt entity, use of elections, or the re-characterization of fees for taxable services as consideration for exempt services. We recommend speaking to your indirect tax advisor who can assist you in determining if this "manufactured" intercompany GST/HST or QST can be reduced.

Mixed-use properties

An apartment or office building may have a combination of exempt and taxable uses (e.g., retail leases on the ground floor of an apartment building). The owner's approach to allocating GST/HST and QST taxable costs to the commercial portions for ITC and ITR purposes can significantly affect recoveries. There may be an alternative, fair and reasonable approach that could increase ITC and ITR recoveries.

If a mixed-use property is sold, the GST/HST and QST rules deem there to be separate sales for GST/HST and QST purposes. It is necessary to allocate the consideration between the taxable and exempt portions.

An increase in the commercial use of a mixed-use property may result in ongoing savings as well as a recapture of ITCs or ITRs previously claimed; of course, a significant change of use from taxable to exempt may result in additional unrecoverable GST/HST or QST. These rules can be complex to apply in practise. The use of such properties from a GST/HST and QST standpoint should be monitored for significant changes.

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