COMMON HST ERRORS IN REAL ESTATE TRANSACTIONS

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Common HST Errors in Real Estate Transactions

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Determining HST-applicability to real estate transactions can be more complicated than many lawyers assume. What's more, a lack of clarity and errors can often lead to substantial unforeseen costs for clients. This is a dangerous combination from a claims perspective.

This paper will discuss the common categories of HST errors and provide tips on how to avoid such errors and flag potential HST problems. This paper does not provide an exhaustive guide to dealing with HST in specific scenarios, and lawyers should make separate determinations as to HST applicability for each transaction they handle.

When does HST apply to Real Estate Transactions?

In Ontario a 13% HST surcharge applies to all real estate transactions—unless the transaction is exempt. The default position under the *Excise Tax Act* is that HST will be added to the cost of the transaction, and lawyers should consider this the presumptive result unless they can definitively show that the transaction in question qualifies as an "exempt supply".[2]

The most common category of "exempt" real estate transactions are residential resales: sales of "used" primary residences from one individual to another. However, there are many exceptions, and exceptions to the exceptions, and exceptions to the exceptions to the exceptions, that can impact whether a specific transaction qualifies.

How is HST collected and paid on real estate transactions?

Generally, collection of HST and remittance to the CRA is the responsibility of the vendor. If a non-exempt transaction takes place, and absent facts that shift the burden of HST remittance to the purchaser (discussed below), the CRA will deem the HST to have been collected by the vendor—regardless of whether HST was, in fact, paid. The vendor will be obligated to immediately pay the HST owing to the CRA—such amounts often constituting five-figures or more when dealing with real property.

Typically, although the vendor is burdened by the CRA with remitting any HST owing on the transaction, it is *de facto* paid by the purchaser as an amount owing from the purchaser to the vendor and considered *on top* of the purchase price. For example, the Ontario Real Estate Association (OREA) Standard Form "Agreement of Purchase and Sale" (APS) includes a clause stating that "if" HST is owing

[1] I wish to acknowledge the assistance of Simona Ristic, Student-at-Law, who undertook research for this paper. The opinions expressed herein are those of the author and do not represent the position of Lawyers' Professional Indemnity Company, the TitlePLUS Department or any other entity, except where expressly stated. The material presented does not establish, report or create the standard of care for lawyers.

[2] Exempt supplies are set out in Schedule V of the *Excise Tax Act* (*ETA*).

on the transaction, it is owing from the purchaser to the vendor "in addition to" the purchase price. Of course, this standard clause can be altered by the parties to make any HST owing "included in" the purchase price, for various reasons.

However, there are situations where the vendor is relieved from the obligation to collect and remit HST owing on the transaction, and instead it is the purchaser's responsibility to make payment.[3] The most common of these situations is where the purchaser is an HST registrant with an HST account number. HST registrants are commercial suppliers of goods and services. Registration is required for any person with supply in excess of $30,000 annually.

If the purchaser is a registrant, the purchaser must self-assess for any HST owing on the transaction and file such assessment with the CRA. When the purchaser is tasked with self-assessing, the vendor must not collect and remit HST, or else the parties may end up double paying.

When an HST registrant self-assesses, they are often able to offset much of the HST owing on the transaction by claiming "Input Tax Credits", shifting the cost of HST to the "second-order purchasers" of the registrant's supply. (This reflects a policy that tax should only be collected "once" for each new "product or service," so the supply chain isn't taxed until the "final product or service," so to speak.)

Generally, the APS states that "if" HST does not apply, the vendor will provide to the purchaser a warranty or assurance to that effect. However, should the CRA determine that HST does, in fact, apply, the amounts will be owing regardless of the agreement and any such assurances by the vendor.

Why are HST errors such a problem?

Nobody wants to pay the HST on a transaction, yet many parties will neglect to discuss or negotiate HST before an APS is signed. This can create an unpleasant surprise just prior to closing when the parties finally turn their mind to it; or, even worse, after closing when the CRA comes knocking.

Remember that lawyers have a responsibility to advise on the HST implications of any transaction unless they have explicitly excluded it from their retainer and advised their client to receive advice elsewhere. Even a global exclusion in the retainer that the lawyer is not giving "tax advice" can be contradicted by actions taken over the course of the transaction, such as drafting documents pertaining to HST indemnities, certificates, registration, or other HST related matters. Lawyers should be certain they understand and have advised their client on the HST implications of the transaction, or explicitly inform their client that they are not advising on HST, remind their client that they should get outside advice anytime HST matters arise during the transaction, ***and document*** every statement made to such effect.

From a claims perspective, the biggest problems with HST mistakes is that the CRA will demand payment immediately (generally from the vendor), regardless of who owes what under the sale contract. This means minor errors or disagreements can have major costs associated with them as a large HST payment must go out the door immediately, creating interest costs and lost opportunity costs.

Consider the example of the CRA demanding an unexpected payment from the vendor for HST that was owing and not paid. Even if a vendor's lawyer "covered their bases" and drafted the agreement such that the purchaser must indemnify the vendor for any "surprise" amounts owing to the CRA, the time it

[3] Or, more accurately, the "recipient" of the taxable supply. Discussed in more detail below.

takes to collect those amounts after the fact (and potentially argue about who owes what in court) can lead to a malpractice claim or a potential claim and repair costs, even if the vendor will likely be made whole down the road.

Common Categories of HST Errors in Real Estate Transactions

Mistakes when determining whether HST applies to a given transaction often fall into one of two categories:

1. Failing to confirm the purchaser's HST registration status; or
2. Mistakenly assuming HST does not apply to a given transaction.

These errors can be made by lawyers for either the purchaser or the vendor and claims consequences can result for lawyers on either side of the transaction.

Confirming the recipient's HST registration status

One common claim scenario we see at LAWPRO involves a vendor's lawyer being provided with an HST registration number by the purchasing party, closing the transaction without collecting HST, and then later being assessed for the outstanding HST by the CRA because the recipient/purchaser was not, in fact, registered with the CRA.

This can be caused by the purchaser mistakenly believing they were registered, providing an incorrect HST number due to confusion or clerical error, the registration had been cancelled or voided before closing the transaction, or any other reason.

Anecdotally, we have seen multiple claims at LAWPRO that involve purchasers providing incorrect HST numbers mistakenly, not out of bad faith, because they confused a corporate registration or payroll number with the correct HST number, have an old number that is no longer valid, or obtained an HST number for the purposes of the transaction but the registration has not been finalized for whatever reason. In all these circumstances, the vendor is liable for the full amount and must pay it to the CRA and then seek reimbursement from the purchaser. Regardless of the error and who made it, the HST owing will become the responsibility of the vendor.

These errors may not be easily rectified. HST registration can only be effected retroactively up to 30 days after the transaction unless registration was mandatory for the purchaser (that being purchasers supplying more than $30,000 in goods and services). Since the vendor usually does not know there has been a problem until they are assessed by the CRA (which is generally much more than 30 days after the transaction closes), HST registration errors can usually not be fixed on the purchaser's end, and the vendor must pay the amount owing. While the vendor can often seek reimbursement from the purchaser, such actions may incur additional costs for the client, leading to a potential malpractice claim.

Lawyers for both purchaser and vender should always conduct an online search with the CRA to ensure that the purchaser's HST number is valid and the purchaser is registered with the CRA. A written record of this search should be kept with the file documentation.

To complete the search online, you will need the HST number provided by the purchaser along with the corresponding business name. To confirm whether the purchaser is currently registered, use today's date as the transaction date.[4]

Two example potential claims may help illustrate the importance of properly documenting and protecting oneself on the question of HST registration. In one potential claim, the lawyer called the CRA and requested a confirmation over the phone that the purchaser was, indeed, properly registered. The CRA agent allegedly provided such a confirmation, but the lawyer took no documented record or evidence of the conversation. Later, it was found that the purchaser was not, in fact, properly registered. While the lawyer in that case may have had a defence against any malpractice claim, proving that they took the necessary steps may have been difficult.

In another potential claim a lawyer instructed their clerk to check the HST registration of the purchaser. The clerk did so and documented the result, but failed to note that the search stated that the purchaser was *not* registered. The lawyer did not check the clerk's work until after the transaction had closed and it was too late to rectify the situation.

In these scenarios, simply running an online check with the CRA as to the HST registration status of the recipient will provide assurances as to whether additional steps are needed in order to avoid unforeseen HST liability falling on the vendor, but remember to document your search by printing the results and adding it to your file.

Types of transactions (and their potential HST implications)

The following is a non-exhaustive list of common types of real estate transactions and the HST implications of consequential facts.

Residential properties

Sales of residential homes that have been previously lived in and have not been substantially renovated by the vendor are generally exempt from HST. Since HST is typically applied to the sale of *new* goods or services, residential homes are generally not taxed after the initial sale by the builder.

This means, however, that *newly built homes*, as well as homes that have been substantially *rebuilt*, will generally be subject to HST when initially sold.

Certain types of residential homes may lose their exemptions, such as the four listed below.

1. *Renovated homes*

Resale homes that have been "substantially renovated" by the vendor are generally not exempt from HST when sold. "Substantially renovated" means that all or substantially all of the building that existed immediately before the renovation or alteration has been removed or replaced.

The CRA generally interprets "all or substantially all" to mean at least 90%. However, this is merely a guideline. While there is no proscribed method of calculating what constitutes "90%", one typical

[4] The online HST registration search can be done at https://www.businessregistration-inscriptionentreprise.gc.ca/ebci/brom/registry/pub/reg_01_Ld.action

method is comparing the square footage of habitable floor space renovated compared to the total habitable floor space of the building.

2. *Rental properties and AirBnbs*

Rental properties used for long-term rentals (generally a period of 60 days or more) are usually exempt from HST on resale (absent substantial renovations or other facts that void the exemption). However, properties used for short-term rentals (rental periods of fewer than 60 days), such as AirBnb properties, do not qualify for such an exemption. Properties are generally considered short-term rental properties if 90% or more of the rentals are for fewer than 60 days.

Properties with a primary use of short-term rental (such as AirBnb or vacation properties included in a rental pool) are therefore considered commercial in nature and taxable when sold. "Primary" use is determined by majority use, so HST would apply if more than 50% of a property's use is for short-term rentals or other commercial purposes. Properties that are used as a primary residence for more than 50% of the time, even if rented on a short-term basis for less than 50% of the time, will generally still not be taxable.

3. *HST rebates for new residential properties*

New residential homes to be used as primary residences or long-term rental units will usually qualify for HST rebates that can reimburse the purchaser for a portion (sometimes substantial portion) of the HST paid on the property. It is a common practice for builders to therefore include HST in the purchase price of a new home, on the condition that the buyer's HST rebate be assigned to the builder.

Although the purchase of a long-term rental unit may also qualify for an HST rebate, such rebates cannot be assigned to the builder, and the recipient must therefore pay the full HST amount owing at the time of closing and be reimbursed through the rebate at a later date.

Lawyers should take care when structuring transactions involving a potential HST rebate, as the CRA may deny rebates if the transaction does not strictly qualify. For example, buyers of a new primary residence that would otherwise qualify for a rebate may lose that qualification if they use a corporate body to take legal ownership of the property, even if title is later transferred to the individuals seeking the rebate. The recipient (that being the person obligated to pay the consideration through the agreement) must be an individual and that same individual (or one of their family members) must then take possession of the property as a primary residence in order to qualify. This can cause problems for a builder that takes assignment of the buyer's HST rebate, only to find that the transaction didn't qualify because of a structural choice.

4. *House flipping and investment properties*

Land used in the furtherance of an "adventure in the nature of trade" is generally considered commercial in nature and not exempt from HST. The most common example of this is "house flipping." While "substantial renovations" before resale will void an HST exemption regardless of the owner's intent, unaltered residences can still be subject to HST at resale if the vendor did not use the home as a primary residence and purchased it for the primary purpose of reselling it at a profit.

Vacant Land, Farmland, and subdivisions

Sales of vacant land by individuals that has been kept for personal use is generally exempt from HST. However, distinguishing between vacant land for personal use and farmland (or other commercial purposes) can sometimes be a complicated matter.

1. *Farmland*

When selling farmland that contains a residence, CRA views the sale as two separate supplies of property. One exempt and the other taxable. An allocation of value between the two "properties" must be obtained in order to determine the amount of HST payable. This can be done by way of valuation or appraisal.

The CRA refers to a "residential complex" portion of the land as including an amount of land that is reasonably necessary for the residential unit's use and enjoyment as a place of residence for individuals.[5] As a general rule, this is quantified as one half-hectare or less, unless it can be demonstrated that lands in excess of one half-hectare are reasonably necessary for the residence's use and enjoyment.

2. *Vacant land*

Vacant land put to a personal use (such as land used by the owner for hunting) is generally not taxable. However, any commercial actions taken by the vendor, such as licensing lumber or resource rights, or renting out a portion of the land, could be seen as transforming the land into a commercial property where HST would apply on resale.

Additionally, vacant land sold by a corporation, rather than an individual, is generally taxable regardless of its previous use.

Lawyers should be careful to inquire as to the complete history of a vendor's use of apparently "vacant land," in order to confirm whether HST does, in fact, apply.

3. *Subdivided land*

Land that has been subdivided into more than two lots is generally *not* exempt from HST. This includes previous subdivisions of the property.

Therefore, for example, if vacant land or farmland including a residence is subdivided into three or more lots, HST will apply to all the properties in question. This would include an unrenovated residential resale.

It is therefore important to inquire as to the subdivision history of the property for an otherwise HST exempt transaction.

Conclusion

HST errors are common within real estate transactions, and can lead to a large, unforeseen HST bill and potential litigation over *who* will pay that bill. The most common errors we see at LAWPRO usually

[5] Based on GST/HST memoranda 19.5 and 19.2.1

involve either a failure to check the purchaser's HST status, or a failure to properly determine whether HST applies to the transaction. The former error is easily avoidable by lawyers for both the vendor and purchaser always running an online check with the CRA to confirm HST registration status.

The latter, however, is a more complicated question and may require additional research on the lawyer's part or assistance from a tax specialist. What's clear is that lawyers should not presume HST will not apply to the transaction, or that the client's accountant, real estate agent, or anyone else has already properly made a determination as to HST applicability.

If a lawyer intends to restrict their retainer and avoid advising on all tax matters, including HST, this should be explicitly conveyed to the client ***and documented***. The lawyer should document additional reminders to the client of this limitation to the retainer at any point where the lawyer is asked to draft documents or convey information pertaining to HST matters.

We have set out questions a lawyer should ask themselves about HST when acting on a real estate transaction.