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Memo

To: Blue Mountains Attainable Housing Corporation
cc: Town of Blue Mountains
From: Sameer Noormohamed
Date: May 12, 2020
Subject: **HST treatment on purchase/operation of land and construction of attainable housing project**

Introduction

The purpose of this memo is to discuss the HST treatment regarding the purchase of land and subsequent construction of an apartment building on the land. Specifically, this memo will review the ownership of the land and building (the real property), treatment of construction costs, operating expenses and landlord rebates with respect to the HST.

Facts and Assumptions

- Blue Mountains Attainable Housing Corporation (“BMAHC”) has been incorporated as an NPO;
- BMAHC is controlled and wholly owned by Town of Blue Mountains (“TOBM”);
- TOBM is a municipality¹;
- Both BMAHC and TOBM are a Public Sector Body (“PSB”)²;
- TOBM recently acquired a parcel of land with an existing structure, which will be demolished in order to construct the attainable housing apartment building;
- The purpose is to build attainable housing or affordable housing and not rent-geared-to-income housing;
- Current plans are to build a four-to-five storey building with approximately 118 units;
- The completed apartment building will not be registered as a condominium complex;
- Of the four-to-five storeys, the ground level of the building will be made up of commercial units;
- The commercial units will be rented at market rents;
- BMAHC will not be receiving any ongoing funding from a government entity (federally or provincially);
- BMAHC is not registered for HST purposes; and
- TOBM is registered for the HST.

¹ Subsection 123(1) of the Excise Tax Act (the “ETA”).

² Subsection 123(1) of the ETA.

Part 1 – Ownership of the Real Property

Currently, the legal and beneficial ownership of the land is held by TOBM. However, consideration is being given to the feasibility of transferring the land to BMAHC and if it is of benefit for the real property to be held by BMAHC.

The sale of the land by TOBM to BMAHC is a taxable supply for HST purposes³. Given that BMAHC is not registered for HST purposes now, TOBM would be required to charge and collect the HST on the sale. If BMAHC was to register for the HST prior to the acquisition of the land, then BMAHC can self-assess the applicable HST and remit directly to the Canada Revenue Agency⁴ (the “CRA”).

The other question is whether it is of benefit for BMAHC to hold ownership of the land and, ultimately, the completed real property. This would boil down to BMAHC’s entitlement to claim rebates or input tax credits (“ITC’s”) on its acquisition expenses, construction expenses and ongoing operating expenses, and if this entitlement would yield a better outcome than that by TOBM. Both TOBM and BMAHC would have the ability to claim an ITC on acquisition costs of the land and subsequent constructions costs (once BMAHC is registered for the HST). However, as explained later in this memo, BMAHC cannot claim any ITC’s or PSB rebates in relation to ongoing operating expenses of the residential complex (all the residential units). ITC’s are not allowed since the supply of the residential complex is an exempt supply. PSB rebates are specifically excluded for property and services acquired for the purposes of making a supply of a residential complex or a residential unit. Therefore, even if BMAHC was to qualify for either form of PSB, it would not have the ability to claim a PSB rebate for ongoing operating expenses⁵. As a result, transferring the land to BMAHC would be of no benefit and it would add the unnecessary transaction of having to transfer the land to BMAHC.

TOBM should retain ownership of the real property while BMAHC can behave as the operating entity to handle the day-to-day operations of the real property. TOBM would enter into a head lease of the real property with BMAHC and, in turn, BMAHC would sublease each of the units in the building to tenants.

To avoid having BMAHC charge a management fee to TOBM, which would be a taxable supply for HST purposes, BMAHC can use lease revenue generated from its tenants to cover its operating expenses (these would mostly be payroll expenses and other administrative expenses). BMAHC should embed a profit component for each unit (residential or commercial) when subleasing to the tenant. This revenue can be used to pay for operating expenses.

For BMAHC to perform its operational activities, it will require the use of the real property which will be supplied by TOBM to BMAHC. In this case, *the supply of real property by TOBM to BMAHC by way of lease, license or similar arrangement of the use or right to use the real property shall be deemed to be a supply of real property as the case may be*⁶. *Where a supply of real property includes the provision of a) real property that is i) a residential complex, (ii) land, a building or part of a building that forms or is reasonably expected to form part of a residential complex, or (iii) a residential trailer park, and (b) other real property that is not part of the property referred to in paragraph (a), the property referred to in paragraph (a) and the property referred to in paragraph (b) shall each be deemed to be a separate property and the provision of the property*

³ Section 25, Part VI of Schedule V of the ETA.

⁴ Subsection 221(2) and 228(4) of the ETA.

⁵ We reviewed the criteria for BMAHC to be considered a qualifying NPO or a designated municipality and given the facts of his proposed project, BMAHC would not be eligible to be either.

⁶ Subsection 136(1) of the ETA.

*referred to in paragraph (a) shall be deemed to be a separate supply from the provision of the property referred to in paragraph (b), and neither supply is incidental to the other*⁷.

To clarify, the right to use real property or the supply of real property by way of lease, license or similar arrangement is deemed to be a supply of real property. Additionally, where a supply of real property is being made and part of the real property being supplied is a residential complex⁸, the remainder of the real property being supplied is considered to be a separate supply of real property from the residential complex (i.e., the portion that will be the residential complex and the other portion are deemed to be two separate properties and two separate supplies). Therefore, two lease agreements will be entered into between TOBM and BMAHC. One for the portion that is a residential complex and another for the commercial component (ground level commercial units).

The supply of the residential complex will be the supply of a multiple unit residential complex (“MURC”). A MURC means a residential complex that contains more than one residential unit but does not include a condominium complex⁹. The lease, license or similar arrangement from TOBM to BMAHC of a MURC is an exempt supply for HST purposes. It is exempt provided that the following criteria are met:

If one-person (TOBM) supplies:

- *Land;*
- *A building;*
- *That part of a building that forms part of a residential complex;*
- *A building that consists solely of residential units; or*
- *A residential complex*

*to another person (BMAHC) for a lease interval during which BMAHC, in turn, supplies the property, or one or more parts of the property, by way of lease, license or similar arrangement and all or substantially all of these supplies are on an exempt basis, then the first lease is also exempt throughout the same lease interval*¹⁰.

Since each residential unit will be leased by BMAHC to an individual for the purpose of its occupancy as a place of residence by the individual, where the period throughout which continuous occupancy of the unit is given to the same individual under the arrangement is at least one month is an exempt supply¹¹, the lease of the MURC by TOBM to BMAHC for the purposes of the above activity is also exempt.

The lease of the commercial component by TOBM to BMAHC will be a taxable supply for HST purposes. In this case, TOBM will charge the HST on the lease to BMAHC.

The sublease of the commercial component by BMAHC to commercial tenants is an exempt supply since most leases of real property by an NPO are exempt for HST purposes. This causes an issue since BMAHC has no way to claim an ITC for the HST it pays to TOBM on its head lease since BMAHC’s output of the real property is an exempt supply. In this case, BMAHC can file an election to treat exempt supplies of real

⁷ Subsection 136(2) of the ETA.

⁸ Subsection 123(1) of the ETA.

⁹ Subsection 123(1) of the ETA.

¹⁰ Section 6.1 of Part I of Schedule V of the ETA.

¹¹ Section 6 of Part I of Schedule V of the ETA.

property as taxable by filing an election with the CRA¹². As part of the necessity to make this election, BMAHC should also register for the HST. BMAHC should register prior to entering into any lease with TOBM.

As an NPO, BMAHC, can make an election to treat the otherwise exempt sublease of the commercial component to be taxable for HST purposes. The election applies to:

- Capital real property;
- Real property that you hold in inventory for the purpose of supplying it; and
- Real property that you acquired by way of lease, license, or similar arrangement to supply all of that property by way of lease, license, or similar arrangement or for the purpose of assigning the arrangement.

As a registrant for HST purposes and once the election is in effect, BMAHC will be required to charge and collect the HST on the lease of the commercial component. BMAHC will also be entitled to claim ITC's on its inputs with respect to the commercial component thereby not leaving the HST on inputs as an expense. Note that the commercial tenants will also be indifferent to the HST since they will likely be able to claim an ITC.

Since BMAHC has not yet acquired the commercial component, it should file an election with an effective date of when it will acquire the commercial component by way of lease. The election must be filed with the CRA within one month after the end of the reporting period in which the election is to become effective.

Part 2 – HST Treatment for Acquisition Costs and Construction Costs

At the time that the land is acquired and during the construction of the building, the real property is not designated to be used in the course of exempt activity. As such, TOBM can claim an ITC for the HST paid on the acquisition of the land and all subsequent construction costs. The construction costs include all hard and soft costs where the HST was paid. TOBM can include these ITC's in their normal HST returns.

The MURC will not be designated for exempt use until such time that the self-supply is triggered. It is important to note that the ITC's on construction costs related to the MURC can only be claimed to a certain point-in-time before the exempt use commences.

The commercial component is not subject to the self-supply rules.

Part 3 – Self-Supply Rules

For HST purposes, the term builder has a specific meaning¹³. It is not restricted to the general meaning of a person who physically constructs a residential unit or a residential complex. In this instance, TOBM will be considered to be a builder of a MURC since TOBM will engage someone to build the MURC.

Where a builder (TOBM) of a MURC leases a unit(s) to another person (BMAHC) who will sublease the residential unit to an individual as the individual's primary place of residence, the TOBM is considered to have self-supplied the MURC. In other words, TOBM will be considered to have sold the property and to have collected the HST on that sale. TOBM is required to self-assess the HST based on the FMV of the

¹² Section 211 of the ETA.

¹³ Subsection 123(1) of the ETA.

entire MURC (i.e., each residential unit) at the time TOBM enters into a lease with BMAHC¹⁴, provided that the MURC is substantially completed.

The tax TOBM is deemed to have collected is equal to the basic tax content (“BTC”) of the MURC at the time the MURC begins to be used in exempt activity and must be included in TOBM’s HST return for the reporting period in which this activity began.

This rule is in place to recapture the previous ITC’s that were claimed since the MURC has been self-supplied and will be for exempt use. The reason for claiming ITC’s during the construction phase is to simply assist with cash flow since these types of projects can take significant periods of time. Note the self-supply rule applies only to the MURC (and not the commercial component) that is ultimately leased to an individual as their primary place of residence.

TOBM will self-assess HST on the fair market value (“FMV”) of the whole of the substantially completed MURC when possession of the first unit is given under a lease, license or similar arrangement as a place of residence of an individual. Normally, substantial completion occurs before occupancy is given to the first individual. Substantial completion means that the construction of the complex is at a stage of completion (90% or more) so that an individual can reasonably inhabit the premises. If possession is given before substantial completion, the tax liability does not arise from self-supply until the time of substantial completion. In any case, substantial completion is deemed to occur no later than the time when 90% of the units in the complex are occupied.

For example, assuming the cost of acquiring the land and subsequent constructions costs, including hard costs and soft costs are \$30MM as they relate to the self-supplied MURC. Let’s also assume that this amount is inclusive of HST. Therefore, the total HST paid would be \$3,451,327.43 (30,000,000 x 13/113). This is the same amount of ITC’s that TOBM should have claimed over the construction period. When the MURC begins to be used in exempt activity, which is presumably several months later since construction time for such a project would be significant, there is a deemed sale of the property at FMV by TOBM and TOBM is deemed to have collected the HST on this sale (this is where the true-up takes place). Let’s say the FMV of the MURC at the time the exempt activity begins is \$32MM (presumably FMV has increased as it typically does with real estate in Ontario).

For registrants, the BTC is calculated using the following formula¹⁵:

$$(A - B) \times C$$

Where:

A is the HST payable for your last acquisition of the property and for later improvements you made to the property;

B is any rebate or refund you were entitled to claim (or would have been entitled to claim if you had not been entitled to claim an ITC) for the HST payable for your last acquisition of the property and for later improvements you made to it, but not including ITCs you were entitled to claim; and

¹⁴ Subsection 191(10) and subsection 191(3) of the ETA.

¹⁵ Subsection 123(1) of the ETA.

C is the lesser of:

- 1; and
- The FMV of the property at the time of the change in use divided by the total cost (not including the HST) for your last acquisition of the property and for later improvements you made to it.

A = 3,451,327.43

B = any eligible rebates that could have been claimed. In this case, once the MURC is self-supplied and is for exempt use, TOBM cannot claim any ITC's. However, it can claim a PSB rebate for the HST paid on the acquisition of the land and the construction costs. As mentioned earlier, this rebate is generally excluded for any prescribed property or service that is acquired for consumption, use or supply by a municipality in the course of making supplies by way of lease, license or similar arrangement of a residential complex or a residential unit. However, it does not apply where the residential complex is supplied under Section 6.1 of Part I of Schedule V (head lease) as is the case between TOBM and BMAHC. The exclusion applies to the subsequent sublease by BMAHC to the residential tenants. The rebates are calculated as follows – Federal portion of the HST is 1,327,433.63 (3,451,327.43 x 5/13) and the provincial portion of the HST is 1,656,637.17 (3,451,327.43 x 8/13 x .78). The sum of the two is 2,984,070.80.

C = 1

Therefore, BTC = (3,451,327.43 – 2,984,070.80) x 1 = 467,256.63 based on the above example.

Again, the above true-up only applies to the MURC. The above calculation is not intended to recapture the ITC's that would have been claimed in relation to the commercial component. Those amounts can remain as an ITC since they are a separate real property, which will be used in commercial activity.

For HST purposes, a MURC is mutually exclusive from a condominium complex. A condominium complex means a residential complex that contains more than one residential condominium unit¹⁶. For HST purposes, a residential condominium unit is a bounded space in a building designated as a separate unit or condominium unit¹⁷ within the residential complex that is registered under the laws of the province. Because the residential complex is a MURC and not a residential condominium unit, the residential units can only be leased to individuals as their primary place of residence and cannot be sold to individuals since they are not distinct from one another.

Part 4 – HST Treatment on Operational Expenses

Normally, PSB's can claim rebates on their HST paid expenditures. However, a PSB rebate is not allowed for the HST paid on property and services acquired primarily for making a supply of real property to another person for use by that person in leasing residential property on an exempt basis. Unless that other person is a PSB and more than 10% of the residential property is restricted to seniors, youths, students, individuals with a disability, or individuals with limited financial resources who qualify for occupancy or reduced rents under a means or income test¹⁸. Therefore, any HST paid on operating expenses related to the MURC are not eligible for a PSB rebate by BMAHC.

¹⁶ Subsection 123(1) of the ETA.

¹⁷ Subsection 123(1) of the ETA.

¹⁸ Subsection 4(1) of the Public Service Body (GST/HST) Regulations.

TOBM can claim a PSB rebate for expenses incurred on operating expenses in respect of the MURC. The above exclusion does not apply to the supply of the MURC by TOBM to BMAHC since the supply is made under a head lease.

For the HST paid on expenses in relation to the other portion of the real property or the commercial component, both TOBM and BMAHC can claim ITC's to the extent that the operating expense is incurred in the course of each of their respective commercial activities and that ITC's are not duplicated. Any expenses incurred in relation to the real property belong to TOBM as recipient of the supply and only TOBM can claim such ITC's as legal and beneficial owner of the real property. Where BMAHC incurs any such expense, it is only incurring the expense as agent on behalf of TOBM and TOBM should claim an ITC for such an expense (it would be advisable to have a principal/agency agreement in place to support/establish the relationship and to have supporting documentation when claiming ITC's). BMAHC is entitled to claim ITC's in respect of its commercial activity (i.e., expenses that it incurs in its own capacity to perform its services).

ITC's for any overhead expenditures (expenses that cannot be directly attributed to the MURC or the commercial component) that relate to both properties will have to be claimed on an allocation basis (e.g., square footage, number of units, etc.). This applies to both TOBM and BMAHC.

Part 5 – HST New Residential Rental Property Rebate

As explained above, because TOBM will be a residential landlord, an ITC to recover the HST paid on the MURC that is accounted for on the self-supply of the MURC is unavailable. However, TOBM may be eligible to claim the new residential rental property ("NRRP") rebate¹⁹ for some of the federal part of the HST and some of the provincial part of the HST if one of the following situations applies:

- You paid the GST/HST on the purchase of a newly constructed or substantially renovated residential complex or an interest in the complex and you lease the complex or units in the complex to another person for residential use by an individual(s);
- You are a builder and you paid or accounted for the HST on the self-supply of a residential complex or an addition to a multiple unit residential complex that you lease to another person for residential use by an individual(s);
- You are a builder and you paid or accounted for the HST on the self-supply of a residential complex or an addition to a multiple unit residential complex and you made an exempt sale of the building and an exempt long-term lease of the land under a single written agreement;
- You are a co-operative housing corporation ("co-op") and you paid the HST on the purchase of a newly constructed or substantially renovated residential complex or an interest in the complex from a builder and you lease units in the complex for long-term residential use;
- You are a co-op and you paid or accounted for the HST on the self-supply of a residential complex or an addition to a multiple unit residential complex and you lease units in the complex for long-term residential use; or
- You paid or accounted for the HST on the self-supply of land that you lease to another person for long-term residential use by an individual(s).

Since TOBM is considered a builder in this case and will have accounted for the self-supply of the MURC, TOBM would qualify for the NRRP.

¹⁹ Section 256.2 of the ETA.

In order to qualify for the NRRP each unit must meet the qualifying unit test. If it does not meet each of the below criteria, the unit is not a qualifying residential unit and no NRRP rebate is available for that unit.

1. *Is the unit a residential unit?*
2. *Does at least one of the following apply?*
 - *You own or co-own the unit, or lease or sublet the unit from another person.*
 - *You have possession of the unit under a purchase and sale agreement.*
 - *If the unit is in a residential complex, you lease or sublet the unit from another person.*
3. *Is the unit a self-contained residence?*
4. *Do you hold the unit for any one of the following purposes?*
 - *To make an exempt lease or sublease of the unit for use by an individual as a place of residence (including an exempt lease or sublease of the unit that you make to another person if that person holds the unit to make an exempt sublease of the unit for use by an individual as a place of residence).*
 - *To make an exempt supply of property or a service that includes giving possession or use of the unit under a lease, license or similar arrangement entered into for the purpose of the unit's occupancy by an individual as a place of residence.*
 - *To make an exempt sale of the unit and an exempt lease of the related land under a single written agreement.*
 - *To occupy the unit as your primary place of residence where another unit situated in the same complex is a qualifying residential unit that you hold for one of the purposes listed above.*
5. *Was the first use of the unit (or is it reasonable to expect that the first use of the unit will be) one of the following?*
 - *You or your relation's primary place of residence for a period of at least one year (or for a shorter period if, after the shorter period, the unit is leased to an individual who will occupy the unit as their primary place of residence).*
 - *A lessor's, or their relation's, primary place of residence for a period of at least one year (or for a shorter period if, after the shorter period, the unit is sold or leased to an individual who will occupy the unit as their primary place of residence).*
 - *An individual's primary place of residence and the individual will occupy the unit continuously for a period of at least one year (or for a shorter period if the unit is sold to another person for use as the primary place of residence of that person or a relation to that person, or taken by the person or lessor, or a relation of the person or the lessor, for use as their primary place of residence).*

In Ontario, there is an HST NRRP rebate for some of the federal part of the HST as well as a rebate for some of the provincial part of the HST. Nevertheless, since TOBM is entitled to claim a PSB rebate, TOBM cannot claim the NRRP rebate for the federal portion of the HST. However, TOBM may meet the conditions for claiming both an Ontario NRRP rebate and a PSB rebate of the provincial part of the HST. In this case, TOBM can claim either the Ontario NRRP rebate or the PSB rebate of the provincial part of the HST, whichever results in a higher rebate.

In theory, it is likely that the NRRP rebate for the provincial component of the HST would result in a better outcome as opposed to the PSB rebate for the provincial component of the HST. If this is the case, the

rebate amount included for “B” in the BTC calculation above will be reduced thereby increasing the remittance as part of the BTC when the self-supply occurs. However, this increase in remittance will be offset by the NRRP rebate for the provincial component of the HST that will be claimed (the CRA wants the self-supply to be reported first, then it will accept the NRRP rebate).

Fortunately, the decision to choose the PSB rebate or the NRRP rebate with respect to the provincial component of the HST is one that can wait until construction is complete and valuations are performed. It is at that time that a determination can be made using concrete figures as to whether the provincial component of the HST will be claimed using the PSB rebate or the NRRP rebate. Note the FMV of each residential unit will have to be available in order to calculate the rebates.

Conclusion

Based on the facts provided, it is our view that ownership of the real property should remain with TOBM since there is no benefit for BMAHC to own the real property. Instead, TOBM can lease both the MURC and the commercial component to BMAHC without any HST implications. TOBM will have to remit the portion of the ITC's it claimed in relation to the land and construction costs that belong to the MURC, however, it will be able to claim a PSB rebate for the federal part of the HST and either a PSB rebate or an NRRP rebate for the provincial part of the HST. Note, if BMAHC were to hold ownership, then it would be entitled to the same NRRP rebate with respect to the provincial component of the HST, but would only be able to claim a certain portion of the federal component of the HST using the NRRP rebate and not 100% of the federal component as TOBM can using the PSB rebate with respect to land and construction costs. Both TOBM and BMAHC can claim an ITC for that portion of the real property that is the commercial component thereby eliminating their HST costs in respect of expenses incurred in the course of this commercial activity.

We are relying upon the facts provided to us by TOBM and BMAHC, the relevant provisions of the ETA as of the date of this memo, the Excise Tax Regulations (“Regulations”), all relevant amendments to the ETA publicly announced prior to the date of this memo and our understanding of the current administrative practices of the CRA, all of which are subject to change or modification by subsequent legislative, regulatory, administrative or judicial decisions. Any such changes could affect the validity of our conclusions. Unless you specifically request otherwise, we will not update our summary for subsequent changes or modifications to law, Regulations or the judicial and administrative interpretations thereof.