AVOIDING THE H.S.T. (Newsletter Summer 2004)

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Confusion about the application of the G.S.T./H.S.T. abounds. The clumsy prose of the Excise Tax Act does little to alleviate the situation: prolonged study of the text is liable to reduce the reader to a gibbering imbecile. H.S.T. is little understood outside the Atlantic Region; we find that initially some clients decline to pay it, apparently labouring under the misimpression that they are exempt because they are based elsewhere. (The Alberta based office of a nationwide accounting firm recently insisted to us that they were entitled to reduce their H.S.T. payment by the "Provincial Sales Tax portion"). The location of the property rather than the owner, dictates whether it, and any services performed for it, attract H.S.T. or G.S.T. (the two are mutually exclusive).

In the Sira Enterprises case, (Newsletter Vol. 2 No. 73), the Tax Court rejected Canada Customs and Revenue Agency's position that fair market value should be based on the sales of other, established properties. In our view, their decision makes clear that "fair Market Value" has to reflect reality. It is the Market Value of the property in its *unleased* state (apart from one unit) and this cannot be ascertained by comparing it with the sales of other properties that have an established market presence, stable cash flow and an operating history, *unless* these factors are also taken into account. Potentially, there are three methods for computing Market Value: in appraisal terminology these are known as the Cost, Direct Sales Comparison, and Income Approaches. The Cost Approach, essentially an exercise to determine what it would cost to purchase the site and construct the building, is not predicated on the property being occupied. The Income Approach is an exercise in converting rental income into a capital value and does presume that the building is occupied. Likewise, the Direct Sales Comparison Approach usually assumes some level of occupancy since investment properties are rarely offered for sale when they are vacant. Thus the application of the Income and Direct Sales Comparison Approaches would require a deduction for the cost of lease-up (marketing and time value of money) and risk (entrepreneurial profit) . . . as well as the cost of any work unfinished at the "first occupancy date", e.g. paving, landscaping, etc. necessary to achieve rent up of the units at market rent. At first blush the Cost Approach appears to be the more reliable indicator of fair Market Value. However it too has to be adjusted downwards if the expectations of the developer fall short of reality. This often occurs because developers usually start to assemble land for their project two years or more before completion. It is not unusual for several developers to have the same bright idea at the same time . . . and to bring their projects on stream together, flooding the market. Rental

expectations are not met and the market value of the property is below its construction cost. Since the inception of most projects, by definition, are timed to begin at the peak of the five year economic cycle, many projects reach completion at the onset of the subsequent recession. This happened in Dartmouth, Nova Scotia, in 1990, when the subsequent oversupply of apartment units coincided with the recession . . .and the market value of the buildings on completion was just half their construction cost. *There is no evidence that CCRA accepts the implications of the Sira Enterprises decision, or the precedents on which it is based.*

Non-Profit Housing

How should you arrive at fair Market Value if the apartment building is erected on the expectation that it will lose money. The *Charleswood Legion Non-profit Housing Inc., Transcona Place Inc. and Her Majesty the Queen 97-45-GST-1; 97-355-GST-1* cases involving non-profit and not-for-profit housing considered this very question. The appellants had erected two apartment buildings, each to be occupied by two classes of tenant: life tenants who paid a substantial deposit refundable on termination plus their share of the operating costs; and "designated unit" tenants who paid what they could afford. The 60 unit apartment building was erected in Charleswood, Winnipeg at a cost excluding land of $5.2 million (the land was sold to the developer, a related party for $1; it was actually worth $400,000). The 30 unit apartment building was erected at a cost of $2.9 million including land, in Transcona about 12 kilometres from Winnipeg city centre. Both buildings generated insufficient income to cover their operating costs and debt service so the Manitoba Housing and Renewal Corporation (MHRC), using Provincial and Federal government funds, agreed to meet the shortfall, including the principal and interest payments on the mortgage, for 35 years. MHRC also secured an option to purchase each property for $1 plus its cost less any mortgage principal paid down. This option could only be exercised if the owners breached their obligation to provide non-profit housing. At the end of 35 years the assets were to be distributed to a corporation whose main purpose was to be the provision of rental housing to "households with core needs". The Royal Canadian Legion was a sponsor in both properties.

The appellant's appraiser concluded that neither property had any value until the 35 year agreement to provide non-profit housing expired. He valued the Charleston property at $14,000 and the Transcona property at $8,800. However, apparently seized with the doubt that grips us all during the morning's wee hours, he also reported that his values for the projects had they not been non-profit, would have been $2.8 million (Charleston) and $1.6 million (Transcona). CCRA responded by polling their various offices across the land to determine the approach that should be used. Three offices responded, each with a different answer, so head office was consulted. Their solution, which differed from any of the others, was to ignore the non-profit agreement with MHRC and treat them as though they were normal investment properties. CCRA therefore adopted the appellant's figures of $2.8 million (Charleston) and $1.6 million (Transcona). The Tax Court decision disagreed with just about everybody and, in our humble opinion, got it just about right.

The judge firmly rejected both the appellant and CCRA's rationale. He made it clear that he thought CCRA were lacking in logic, adopting $2.8 million for the Charleston property, given that its construction cost was $5.2 million, and that the land was worth $400,000. The Court decided that *"the fair market value of the two subject properties should not exceed their cost (Charleston $5.6 million; Transcona $2.9 million) and should not be lower than the amount of the mortgage loans used to finance their acquisition (Charleston $3.9 million; Transcona $2.2 million)".* However since the Court had no power to increase CCRA's appraised values, the latter were adopted.