

Tax Concerns On The Purchase And Sale Of Commercial Real Estate

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The purpose of this article is to review select tax issues under the *Income Tax Act* (Canada) (the “**ITA**”) and the *Excise Tax Act* (Canada) (the “**ETA**”) related to the purchase and sale of commercial real estate between unrelated parties without an associated business. This article is not intended to be an exhaustive review. We have selected certain issues that occur frequently and are often dealt with incorrectly. There are tax considerations which should be made at each stage of a typical commercial real estate transaction.

I. The Purchase Agreement

The purchase agreement for the property (in whatever form) should be the guiding document regarding the treatment of tax issues on closing of the transaction. However, we often see the following tax issues handled incorrectly or omitted altogether: (i) allocation of purchase price; and (ii) goods and services tax under the ETA. There are also issues related to the sale of real estate by a non-resident (i.e., withholding tax) and numerous other considerations where the transaction also includes the purchase and sale of a business operating on the property, but those are beyond the scope of this article.

A. Allocation of Purchase Price

The allocation of the purchase price among assets will determine the tax payable by the vendor on the sale. In a commercial real estate transaction, there are multiple classes of assets that should be considered, such as land, buildings, fixtures, chattels (e.g., building contents), contracts and intangible assets (e.g., goodwill and intellectual property for the name of a property). The interests of the purchaser and vendor usually do not align on allocation and negotiation is required. This is because the vendor wants the allocation to result in as little tax payable as possible, while the purchaser wants to be able to allocate the

purchase price such that greater future depreciation and deductions are available. If the vendor pays the least possible tax, fewer deductions will be available to the purchaser. The purchase agreement should require that the parties work together to agree on the allocation using some objective standard (i.e., commercially reasonable efforts) by a certain time (i.e., the condition date or by a certain number of days prior to closing). Failing which, the agreement should allow the parties to make their own allocation for tax purposes. If no purchase price allocation is agreed, the risk is that Canada Revenue Agency may determine the allocation for the parties pursuant to Section 68 of the ITA and this determination likely will not satisfy either party's objectives.

B. Goods and Services Tax

There are certain exceptions where goods and services tax ("**GST**") may not be applicable, but where commercial real estate is sold between unrelated parties, GST is almost always applicable at the rate of 5% of the purchase price. The obligation under the ETA is for the vendor to collect and remit GST on the sale unless an exemption applies. Subject to certain exceptions, the vendor is not required to collect and remit GST if the purchaser is registered for the collection and remittance of GST. This does not mean that there is no GST. The purchaser must report the tax on a self-assessment basis and a full or partial input tax credit offsetting the GST payable may be available.

The purchase agreement should document that the purchaser must pay the amount required for GST to the vendor on closing, unless it is registered for GST, in which case it will self-assess and remit. There should also be an obligation for the purchaser to provide proof of registration for GST together with an indemnity in favour of the vendor on the closing date. If another exemption is being claimed by either party, that exemption should be documented.

II. Due Diligence & Purchase Structure

Once the purchase agreement is finalized and executed, there are additional concerns for the purchaser. During the due diligence phase, we recommend that a purchaser verify whether the vendor owes any amount under the ITA, the ETA and certain other legislation administered by Canada Revenue Agency (which the purchase agreement ideally allows for). Even if there are no registrations against title to the property made by a taxing authority, there is some risk that one could appear in the intervening period.

There are concerns relating to the purchase structure under both the ITA and the ETA. For a tax effective purchase structure, the setup varies from transaction to transaction and requires personalized advice. GST concerns include whether it will be a single purchaser or multiple purchasers under some co-ownership arrangement. Where the purchaser is a co-ownership (with or without a bare trustee taking title to the property), the GST considerations become even more complicated and it is necessary to determine which entity will handle GST for the property. An election under Section 273 of the ETA whereby the co-owners appoint an

“operator” for GST purposes may be relevant.

III. Closing

On closing of the transaction, it becomes time to ensure the correct documents are executed to document and give effect to the above concerns

1. if a purchase price allocation is reached, the parties should enter into a purchase price allocation agreement on or before the closing date; and
2. the purchaser should execute a GST declaration or certificate setting out the purchaser's GST registration number. The vendor should also insist that this include an indemnity in the vendor's favour to avoid any potential liability. On closing, the vendor should confirm the purchaser's GST registration number with Canada Revenue Agency.

The tax issues discussed in this article can become very complex and will be costly if handled incorrectly. You should consult your tax advisors early on in the process and insist on solicitor's approval of your purchase agreement. We would be pleased to discuss any of these issues with you or your clients.

To speak to a taxation lawyer regarding the purchase or sale of commercial real estate or another topic, **contact one of our Tax Law lawyers today.**

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