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## Ontario Update: Preparing for the Harmonized Sales Tax

In March 2009, the Ontario government announced that it would be harmonizing its PST with the federal GST in order to create a single consumption tax of 13% effective July 1, 2010 (“Harmonized Sales Tax” or “HST”). Other provinces have previously implemented a similar regime or are about to follow suit. The change brings with it the need for both landlords and tenants to understand and plan. From a leasing perspective, that includes ensuring that their leases adequately address the new system.

### Before HST

Currently, separate consumption-based taxes are collected by the Canadian (federal) and Ontario (provincial) governments. At the federal level, a Goods and Services Tax (“GST”) is charged at the rate of 5%. GST applies to most transactions generally seen within the commercial leasing context, including the payment of rent. Except for GST-exempt businesses, GST paid out is credited against GST collected from customers, as an Input Tax Credit (“ITC”). (A GST-exempt business provides goods and services that are exempt from GST, so they collect none. Similarly, they make no claim for ITCs. Health care services (including dental services) are GST-exempt, as are educational services, child and personal care services (such as day care), legal aid services, and supplies provided by charities, public bodies and financial services providers (such as banks.) For an average business (i.e. not one that is GST-exempt), the ITC amounts add up to more than the GST payments on purchases of goods and services, and the result is that the GST is neutral except as it relates to cash flow.

At the provincial level, an 8% Provincial Sales Tax (“PST”) is applied to some goods and services. Unlike the GST, there is a plethora of PST-exempt goods and services, including rent payments. Exemptions may be available to businesses

depending on the type of purchaser involved, the type of goods purchased and the use to which the item is to be put.

Although both taxes are consumption based, one (the GST) is largely considered as less painful than the other (PST) because the latter is a true cost of doing business, albeit applied to a smaller basket of items.

Most lease forms express an obligation on the part of the tenant, and in some cases on the part of the landlord, to pay GST on rent and other charges. In the absence of a clear contractual obligation, legislation requires that it be collected on taxable supplies (e.g. rent), so there is little likelihood that a party will avoid paying it and face no sanctions. However, from a remedies standpoint, it is always better to point to a clear contractual provision expressing an obligation to pay. Some lease forms allow landlords to recover from their tenants the cost of GST paid or payable on costs included in “operating costs”. Some lease forms require that these amounts be offset by any claimable ITCs. By and large, since GST was first implemented in 1991, there has not been a lot of deep thought given to whether lease forms adequately treat the subject of GST, since the taxation system has taken hold of Canadian business consciousness and is widely understood, applied and accepted as “ordinary”.

### After HST

The introduction of the HST involves blending GST and PST into a single tax to be administered by the Canadian (federal) government. As a result of amalgamating the two taxes, some goods and services previously exempt from PST will become subject to 13% HST. Generally, we can expect that more goods and services will be taxed; this new revenue is exactly why the Ontario government is making the change.

The changes being implemented to the consumption tax system in Ontario will generally not significantly increase the operating

costs of businesses who are eligible for ITCs. On the contrary, the amalgamation will likely result in a net savings for those businesses because previously PST was not subject to any ITC but was merely an out-of-pocket cost.

Unfortunately, businesses currently exempt from GST will see an increase in their operating expenses as they will be required to pay the increased HST on their rent and other expenses but will still not be eligible to claim any ITCs.

In addition, certain restrictions will apply respecting the ability of businesses with annual taxable sales above \$10 million ("large businesses") to claim an ITC on certain transactions. In particular, for the first 5 years following the implementation of the HST, large businesses will not be able to claim ITC's on the 8% PST paid on the following: energy; telecommunications services (excluding internet services and toll-free numbers); vehicles with a weight below 3000 kilograms (and their associated fuel); and food, beverages and entertainment. The ITCs for these items are to be phased in over the three years following implementation of the HST. For the period July 1, 2010 to June 30, 2015, this change will effectively increase, by 8%, the cost of utilities (excluding water) for commercial property owners and managers who qualify as large businesses. (NB: There is some ambiguity with regard to whether the restriction will apply to utility bills in their entirety, and whether the definition of 'large business' will apply to a building owner or the property manager.)

## What to do to get ready for HST

Attention should be paid to ensuring that offers to lease, letters of intent, and leases that

will be in effect as of July 1, 2010 properly address HST. Many standard form leases provide that the tenant will be responsible to pay GST, but refer only to GST and therefore may not be written broadly enough to capture the combined tax. While some lease forms already include broad definitions of "Sales Taxes", it is prudent to evaluate all standard form leases, letters of intent, offers to lease and other agreements and remove any references to GST or narrow definitions of sales tax in favour of capturing a broader range of possible consumption-based taxes. These broader terms should include the concept of "any harmonized sales or other consumption tax now or in the future imposed by any level of governmental authority, whether against rent or any other amounts".

Likewise, "operating costs" should be defined to include HST in respect of which no ITC is available.

An irritant in the area of consumption based taxes has arisen over the years around the issue of whether a landlord must pay GST on a leasehold improvement or other allowance paid to the tenant as consideration for the lease. Some landlords routinely agree to pay while others agree to pay only if the taxing authority requires GST to be paid. The transition to HST should not cause any change in thinking, except that if the HST is not required to be paid by the taxing authority, perhaps it is fair to routinely qualify that obligation. An unnecessary 13% outlay is worth avoiding, even if it does count as an ITC.

Several provinces have already graduated to the HST level; they are comfortable with that regime and report no major administrative difficulties for business. Hopefully Ontario will enjoy a similar experience.



Our secret for closing files lies as much in what is taken out as in what is put in. By eliminating exorbitant expenses and excess time, by shortening the process through practical application of our knowledge, and by efficiently working to implement the best course of action, we keep our clients' needs foremost in our minds. There is beauty in simplicity. We avoid clutter and invest in results.

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