THE TAX COURT OF CANADA

YOU CAN'T LOSE WITH REAL ESTATE, CAN YOU?

Ko et al. v. The Queen
2003 GTC 532
KEYWORDS: GST ■ REAL ESTATE ■ SEVERANCE

Ko et al. v. The Queen provides an interesting review of certain rules that can have an impact on the determination of whether the sale of severed or subdivided real property is exempt from goods and services tax (GST). The *Ko* case upholds the minister of national revenue's assessment of GST on the transfers of two lots where, arguably, GST should not have applied. *Ko* also raises broader issues relating to the nature and scope of retroactivity in the GST legislation,[13] when a supply of real property (or, for that matter, any kind of property or a service) is considered to be made under the law, and the timing of GST liability.

The Kos acquired a parcel of land that they subdivided into five lots. They intended to retain two lots on which to build their own residences. The other three lots were sold at a profit to subsidize their acquisition and the construction of their residences. While the GST status of the three lots sold at a profit was clear, the case revolved around the GST status of the other two lots. The Tax Court swept these two

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13 RSC 1985, c. E-15, as amended, parts VIII and IX (herein referred to as "the GST legislation").

transfers into the Kos' "commercial activity" and found that they were taxable. We believe that the court erred in these findings.

THE SPECIFIC ISSUES

Mr. Ko and his wife, Mrs. Ko, and his brother and sister ("the siblings") each owned a one-half undivided interest in a parcel of land in Surrey, British Columbia. When the Kos acquired the property, a detached house was situated on the land. On January 20, 1998, the Kos subdivided the property into five separate lots, and on April 5, 1998, they registered as a partnership ("the partnership") under the GST legislation.

When the Kos sold lot 2, which contained the original residence, the sale qualified for the basic "used residential complex" exemption.[14]

When the Kos sold lots 1 and 4 to unrelated third parties, they charged and collected GST on the sales, and reported and remitted the tax with the partnership's GST returns. The Kos entered into an agreement to sell lot 5 to Mr. and Mrs. Ko for nil consideration in October 1998 and to sell lot 3 to the siblings for nil consideration in December 1998. (It is unclear whether the sales were completed at the same time as, or subsequent to, the signing of the agreements.) No GST was charged, collected, or paid on the transfer of these lots.

On March 6, 2001, the minister of national revenue issued a notice of reassessment against the Kos for $17,920.00 of unpaid GST, calculated as 7 percent of the fair market value (FMV) of $256,000 for the two lots, plus interest of $2,138.02 and penalties of $2,563.42. The Kos appealed the reassessment to the Tax Court of Canada.

In dismissing the appeal, the court appears to have relied on the anti-avoidance rule in section 155 of the GST legislation. Under this rule, where a "taxable supply" of property (or a service) is acquired for less than its FMV from a vendor with whom the purchaser does not deal at arm's length, and the purchaser would be ineligible to claim an input tax credit (ITC) to recover 100 percent of any GST payable on the purchase, the purchase is deemed to have been made for FMV and to be subject to GST on this basis. In our view, the court erred on the more fundamental question whether the transfers of lots 3 and 5 were in fact taxable supplies.

The court first addressed exactly who sold the lots, the Kos in their capacity as individuals or as members of the partnership. Despite certain evidence to the contrary, the Kos argued that they did not conduct their activities as part of a partnership. Examining section 2 of the BC Partnership Act,[15] the court found that the Kos did subdivide and sell the lots through the partnership. Section 2 provides, "Partnership is the relation which subsists between persons carrying on business in common with a view of profit." According to the court, the following facts supported its finding:

14 Section 2, part I of schedule V to the GST legislation.

15 RSBC 1996, c. 348, as amended.

- The Kos registered for GST purposes as a partnership.
- The Kos reported and remitted the GST collected on the sales of lots 1 and 4 to third parties on the partnership's GST returns.
- All four Kos co-owned the five lots created by the subdivision of the original parcel.
- The Kos transferred lots 1, 2, and 4 to third parties for profit.

We dispute the court's finding that the transfers of lots 3 and 5 were part of the partnership's business activities. The lots were transferred for nil consideration to non-arm's-length parties, *clearly without a view to making a profit*, so that those transfers could have been determined to be part of the individuals' (the Kos') activities in their own right, quite separate and apart from the partnership's activities.

Although we do not agree with the conclusion that the sale of the two lots for nil consideration formed part of the partnership's "commercial activity," this finding would have disposed of the appeal.[16] The court, however, went on to consider whether any of the exemptions for lots sold for nil consideration would have been available had it been determined that the lots were transferred by the Kos personally. These exemptions apply only to non-commercial sales by *individuals*.[17]

Mr. and Mrs. Ko were building a house on lot 5, and they argued that section 3, part I of schedule V to the GST legislation ("the owner-built home exemption") applied. This exemption applies to an individual's sale of an owner-built home where the individual[18] has used the home primarily as a place of residence after the construction has been substantially completed. The exemption does not apply if the individual has claimed an ITC respecting his acquisition of, or any improvement to, the property.

The court rejected this argument on the basis that when the "supply" was made in October 1998, no "residential complex"[19] existed on lot 5. The house located on the lot was not finished or approved for occupancy until December 1998, and the court found that the "supply" by way of sale of a less than substantially completed house is not a sale of a "residential complex." The court determined that the supply of lot 5 was made in October 1998 on the basis of section 133 of the GST legislation. Under section 133, a supply of property (or a service) made pursuant to an agreement is deemed to have been made at the time the agreement is entered into, and

16 Under subsection 123(1) of the GST legislation, any supply made in the course of a "commercial activity" constitutes a "taxable supply." Under paragraph (a) of the definition of "commercial activity" in subsection 123(1), a business carried on with a reasonable expectation of profit by a partnership, all of the members of which are individuals, constitutes a "commercial activity," unless and except to the extent that the business relates to the making of exempt supplies. In addition, under paragraph (c) of the same definition, a supply of real property, other than an exempt supply, as well as any related activities, constitutes a "commercial activity."

17 An individual is a "natural person" under subsection 123(1) of the GST legislation.

18 Or an individual related to the individual or a former spouse or common law partner of the individual.

19 As defined in subsection 123(1) of the GST legislation.

the provision of the property (or service) under the agreement is deemed to be part of that supply.

Had the owner-built home exemption applied, Mr. and Mrs. Ko would have paid unrecoverable GST on their construction costs, instead of on the full FMV of the real property. The result of the court's decision is harsh because clearly this transfer fits within the intended scope of the owner-built home exemption. Understandably, the court did not wish to apply too liberal a definition of "residential complex" and thereby create unintended mischief in the application of the many complex rules in the GST legislation that depend on this definition.

As previously stated, it is unclear whether the transfer of ownership to Mr. and Mrs. Ko occurred at the time the agreement was entered into or after the house was substantially completed and they had moved into it. Assuming that the ownership was transferred after the house was built, the court could have been more creative in determining when the supply occurred—for example, by ignoring section 133 and finding that the supply occurred when the ownership of lot 5 was transferred, so that the owner-built home exemption could have applied.[20] Alternatively, regardless of when the transfer of ownership occurred, the court could have interpreted the deeming language in section 133 broadly and found that the supply of the lot *and* the completed "residential complex" was deemed to have been made at the time the agreement was entered into.

Yet another possibility, accepting the court's finding that there was no "residential complex" on lot 5 at the time of the "supply," is that the "subdivided lot exemption"[21] could have applied. Paragraph (2)(e) of the subdivided lot exemption provides that the exemption does not apply to a "residential complex or an interest in a residential complex."

Lot 3, which was transferred to the siblings, was vacant land. The court found that the subdivided lot exemption was not available with respect to the transfer of lot 3 on the basis of paragraph (2)(a) or (b) of that exemption. Under subparagraph (2)(a)(i), the exemption does not apply to real property that is "capital property"[22] that is used more than 50 percent of the time in a business carried on by an individual with a reasonable expectation of profit. Under subparagraph (2)(b)(i), the exemption does not apply to "a supply of real property made in the course of a business of" an individual (such as the sale of land held in inventory). In other

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20 The decision in *Lepage*, infra note 24, discussed in the second part of this case comment, is an example of such judicial creativity.

21 Section 9, part I of schedule V to the GST legislation.

22 Subsection 123(1) of the GST legislation defines "capital property" in reference to the definition found in subsection 248(1) of the Income Tax Act, which provides:

> "capital property" of a taxpayer means
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> (a) any depreciable property of the taxpayer, and
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> (b) any property (other than depreciable property), any gain or loss from the disposition of which would, if the property were disposed of, be a capital gain or a capital loss, as the case may be, of the taxpayer.

words, the court found that the activity of acquiring, subdividing, and selling the original parcel of land was a business activity, whether it was undertaken directly by the Kos or indirectly through the partnership. As noted above, one could take issue with the finding that the transfers of lots 3 and 5 for nil consideration constituted business activities undertaken with a view to profit. One could reasonably argue that the Kos, as individuals, transferred personal-use real property.

In general, the sale of any subdivided or severed land after April 23, 1996 is subject to GST. There is an exception to this general rule, however, where a person acquires a subdivided lot for personal use from a related vendor.[23] If lots 3 and 5 were personal-use property to the Kos, the subdivided lot exemption could have applied.

BROADER THEMES RAISED BY KO AND EARLIER DECISIONS

In *Lepage v. The Queen*,[24] the minister assessed GST on the sale of a piece of land subdivided into six lots. The sale agreement was entered into on March 7, 1996, and the transaction closed in August 1996. The law was amended on April 24, 1996, between the date of the agreement and the date of closing; therefore, the subdivided lot exemption would not apply if the supply was made when the transaction closed in August 1996.

The taxpayer (vendor) argued that the supply was made when the agreement was entered into because the purchaser acquired an equitable interest in the real property at that time. The minister argued that an equitable interest transfers only if the purchaser can obtain an order for specific performance; in *Lepage*, the purchaser could not obtain specific performance until on or about the closing date because conditions precedent under the agreement were not satisfied until that time. The Tax Court found that the supply was made at the completion of the transaction because the sale agreement remained subject to conditions precedent. Surprisingly, the court in *Lepage* did not consider section 133 of the GST legislation.

In obiter, the court expressed concern that if it accepted the taxpayer's argument, it would logically follow that GST would become payable on the sale of the equitable interest in the real property when the sale agreement was entered into. Subsection 168(5) of the GST legislation generally triggers GST payable on the earlier of the day on which ownership (such as an equitable interest) is transferred and the day on which possession is transferred under the sale agreement. We take issue with the court's logic. The rules for determining when a taxable supply is made are entirely different from those for determining the timing of the consequent GST liability. The court could have avoided any concern with the timing of GST liability and ruled in the taxpayer's favour by finding that the taxpayer made an exempt supply on March 7, 1996 (before the effective date of the amendment), at the time the agreement was entered into, pursuant to section 133.

23 The purchase could also be from a former spouse or common law partner.

24 2001 GTC 324; [2001] GSTC 21 (TCC).

While not specifically addressed in *Ko*, the April 24, 1996 amendments to the subdivided lot exemption have raised concerns in other cases about their possible retroactive effect. In *Arsenault v. The Queen*,[25] the Tax Court found that severances that occurred before the effective date of the amendments and that would result in GST being charged on the sale of a lot in 1997, would have retroactive effect. As the amendments did not expressly state that they could have retroactive effect, they were presumed by the court not to do so.

Subsequently, the Ontario Superior Court of Justice chose not to apply *Arsenault* in *Rive v. Newton et al.*[26] and reached the opposite result in considering the identical issue. The court applied the subdivided lot exemption to the sale of a lot in 1999 even though the vendor had made multiple severances to the property, of which the lot formed part, before the April 24, 1996 amendment date. In contrast to the decision in *Arsenault*, the court found that the amendment would have "no retroactive effect in a situation involving successive facts unless all of the facts arose prior to the [statutory amendment]."[27]

That leaves the law with contradictory decisions from two different courts, the Tax Court of Canada and the Ontario Superior Court of Justice. The Tax Court decision is not binding on future courts because it was decided under the informal procedure, and the Ontario Superior Court's comments on the application of the subdivision lot exemption are arguably not binding on future courts because they were made in obiter. (*Rive* involved a contract dispute in which the minister's assessment was binding with respect to the application of GST.) In our opinion, since the purpose of the amendments was to put developers and non-developers on an equal competitive footing by treating non-developers' sales of subdivided lots as taxable, the better view is that the reasoning in *Rive* should apply.

In all, the cases raise more questions than they answer. Should taxpayers take into account severances made before the effective amendment date of April 24, 1996 when deciding whether the subdivision lot exemption applies? What rules determine *when* a supply of real property by way of sale is made? Should recourse be had to section 133 (as in *Ko*)? Or is a supply made upon the fulfillment of any conditions precedent (as in *Lepage*)?[28] One is left wondering what a vendor and a purchaser should do when faced with a myriad of unresolved issues in determining the GST status of a sale transaction, both before entering into the sale agreement and before closing.

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25 2000 GTC 953; [2000] GSTC 88 (TCC).

26 2001 GTC 3566; [2001] GSTC 85 (Ont. SCJ); aff'd. [2003] GSTC 49 (Ont. CA).

27 Ibid., at paragraphs 34; 36 (SCJ).

28 The better interpretation appears to be that section 133 should apply since this interpretation is firmly rooted in the GST legislation itself.