

INSURANCE ISSUES:

Risk Management

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GST traps for the unwary

“GST is a trap for the unwary. It is even a trap for the wary. I suppose creating better awareness of the issues and pitfalls is all that can be done.” – advice from a lawyer who reported a claim when the company he had acted for in the sale of a commercial property was assessed the GST that the purchaser ought to have paid, but never did.

WE TOOK THIS lawyer’s advice to heart. In this *Insurance Issues*, we first give details of the GST pitfalls that lead to reports to us. We then draw on our experience and those of reporting lawyers to offer tips that you can follow to avoid getting trapped. Because the risks we identify exist regardless of whether the tax is assessed as Goods and Services Tax (GST) or as part of the Harmonized Sales Tax (HST), we refer to both as “GST.”

This *Issues* is of particular relevance to real estate and commercial lawyers. However, because GST issues can surface in other areas of law, it is recommended reading for all lawyers. And although we touch on some law in relation to GST, it is not a legal authority. GST is a complicated area involving various legal issues, including statutory liability, exemptions, rebates and elections, and lawyers must understand how it affects their practice. However, as with the Winter 2010 *Insurance Issues* that dealt with the risky business of income tax, the tips we offer will help you navigate those risky waters more safely.

Trap: Not flagging the GST issue

Sometimes lawyers don’t realize that potential GST implications exist. Here are

some examples from lawyers acting on real estate transactions:

- A lawyer didn’t appreciate that, because his vendor client was in the business of buying and selling properties, GST needed to be collected from the purchaser and remitted to Canada Revenue Agency (CRA).
- A lawyer acted for the purchasers of a condominium that was part of a rental pool. The purchasers were pursued by the vendor after the vendor was assessed GST, and then claimed against the lawyer.

Lawyers providing other types of services have also missed the lurking GST issue. For example:

- A lawyer filed a builder’s lien for a subcontractor and forgot to include GST in the lien amount.
- A lawyer advised a director on a company’s liability risks but failed to warn about the risk of unpaid GST.

GST can also affect settlements, as seen by these reports:

- A lawyer negotiated a settlement of a client’s sales service contract that made the client liable for statutory payments,

and later realized the client was liable for GST.

- A lawyer’s client was provided with a first mortgage as security for the settlement of a lien claim. CRA later claimed priority over the mortgage for unpaid GST, and the client claimed against the lawyer.
- As part of a settlement, monies owed to a lawyer’s client for royalties and other amounts under a licence agreement were set off against the client’s debt. The lawyer did not consider whether GST was payable on the set-off amounts and the client may be exposed to a claim by CRA.

In some cases, the *Excise Tax Act* also deems a settlement payment to include GST – a trap for the unwary litigator whose client may be liable to pay the GST portion of a hard-won settlement over to the government.

Tips

- GST will likely come into play in any matter in which property (goods, intangibles, realty) or services are exchanged, because conferring a right of

any kind is a “supply” for GST purposes. However, because it may be relevant in other situations, ask yourself if there are any GST implications on every matter you act or advise on.

- If you practise regularly in an area of law, determine any GST implications in advance so that you can set up systems to ensure the issue is always flagged.
- Incorporate a GST query into your checklists.

Trap: Flagging the issue but getting it wrong

Lawyers get caught giving the wrong advice on whether a matter attracts GST. Here are some examples from lawyers acting on real estate transactions:

- A lawyer acted for a vendor selling a newly constructed home and wrongly allowed his client to sign a GST exemption certificate on the basis that the property was “used residential.”
- A lawyer acted for a vendor claiming that the sale of vacant land was GST-exempt when it was not, as the land was subdivided. The vendor claimed against the lawyer.
- A lawyer acted for a purchaser of land from a corporate vendor, and wrongly advised that the transaction was GST-exempt as it was bare land. In fact, the exemption did not apply as the vendor was a corporate entity.

We receive reports from other areas of law, as well:

- A lawyer acted for a company that sells franchises, and gave preliminary, and possibly incorrect, advice about the applicability of GST to franchise fees.
- A lawyer acted for a tenant leasing property from the provincial government, and may have wrongly assumed that GST does not apply in the particular circumstances of the transaction.

Other times, the lawyer knows that GST is attracted, but is mistaken about how it operates:

- A lawyer acted for a developer of homes on land held pursuant to a long-term lease. The lawyer assumed that the GST operated as it would if the transaction

involved fee simple sales, and wrongly structured the direct 99-year-subleases so that the “purchasers” were charged GST.

- A developer’s lawyer calculated a GST rebate. The purchaser assigned the rebate to the developer who submitted it and received a credit from CRA. CRA reassesses as the developer included extras in the statement of adjustments that were not considered by the lawyer in calculating the rebate, and is not entitled to the amount of the rebate claimed.

Tips

- Some areas of practice, such as real estate and commercial law, require a basic working knowledge of GST. If you practise in such an area, learn the law and keep up to date.
- Recognize the potential complexities of GST law. One lawyer attributed his mistake to “the complexity of GST issues when transferring shares of a company that holds land,” and another noted that “mixed use properties [here a small rural acreage] are difficult to determine in terms of whether or not GST is attracted.” Be realistic about what you know and, if you are not certain, do not guess. Research any area that you do not know cold or get the advice that you need. A lawyer whose report was prompted by “handling a GST issue when the client should have been advised to seek accounting or GST tax advice” recommends other lawyers avoid such mistakes by “knowing one’s limit of what you are comfortable in giving legal advice on.” Pass the risk to the client by clarifying what you are advising on and what you are not, and confirm it in writing.
- If you are acting only on part of a matter and GST implications might arise from related matters, clarify the limits on your retainer.
- Take the time you need to carefully think through all the GST issues. As one lawyer noted, “e-filing, working to deadline, etc., leaves precious little time to properly digest and process the nature of property conveyances.”

Trap: Making bad assumptions about your client’s circumstances or GST knowledge

Make assumptions about your client’s circumstances or knowledge of GST at your peril. We see reports in which lawyers get the GST issue wrong because they didn’t adequately canvass all the facts relating to a transaction with their client:

- A lawyer acted for both parties on a conveyance and assumed that the transaction was GST-exempt. In fact, the vendor was in the business of property development and GST may be applicable.
- A lawyer acted for the vendors of recreational property who were registrants and had claimed an input tax credit for the GST payable on their purchase – commonly referred to as a “GST deferral.” As a result, their sale was subject to GST, and they didn’t ensure that the purchasers paid the GST. The vendors were reassessed by CRA and blamed the lawyer.

Lawyers can also find themselves targeted if they rely on a client’s (incorrect) advice about whether or not GST is attracted. For example:

- A lawyer allowed his vendor client to sign a GST exemption certificate sent (inappropriately) by the purchaser, based on the client’s assurance that no GST was payable. The lawyer later discovered that his client based his understanding on the contract term stating that GST was the purchaser’s responsibility.
- A lawyer acted on the sale of a residential property on acreage, held by a family company. The son advised that he had investigated the matter and the transaction was GST-exempt. In fact, it was not, but the lawyer had nothing in writing to confirm the son’s advice.

Tips

- As one lawyer noted, the problem she faced was caused by “not adequately canvassing the GST issue with the client.” Spend the time you need with your client, gathering information and explaining your advice.
- Do not assume a higher level of legal knowledge simply because a client is

more sophisticated or business-savvy. One lawyer noted, "I may not have clearly explained to the clients the potential applicability of GST to their real estate purchase," and recommends dealing clearly with the issue through a "thorough initial reporting/retainer" letter.

- Be careful before you accept a client's assurance that GST is – or is not – payable. Appreciate that your client may not really understand how the GST operates, or has perhaps misinterpreted a contractual term. And if it's appropriate to rely on your client's advice, confirm in writing that you are doing so. Pass the risk and responsibility for the advice back to the client, where it belongs.

Trap: Not adequately reviewing contracts and related documents

Sometimes, mistakes are made simply because lawyers don't carefully review contracts or related documents. For example:

- *A lawyer acted for a client selling equipment and understood that the purchaser would be liable for the GST, but overlooked a term in the contract providing that the vendor was liable.*
- *A lawyer acted for the purchaser of residential property and misinterpreted the agreement of purchase and sale. Contrary to the terms of the contract, the lawyer proceeded on the basis that the purchaser, if not entitled to the GST rebate, was required to pay the developer an amount equivalent to the rebate.*
- *In a real estate conveyance in which the purchaser assumed liability for self-assessing the GST, the vendor's notary placed the lawyer on an undertaking to provide the purchaser's GST registration number. The registration number was never provided and, in fact, the purchaser was not registered.*

Tips

- Carefully review the contract for any provisions that may change the party liable for GST. The contract may be silent, or it may spell out an agreement between the parties as to who will take

it on. If silent, case law currently supports the view that the purchaser will pay the tax in addition to the purchase price.

- As with any document, take it slow – take the time you need to properly and thoroughly review the contract. As one lawyer caught out in a real estate conveyance advised, "ensure that information is fully reviewed prior to completion." It will also help you avoid breaching an undertaking that you simply overlooked.

Trap: GST registrants

The *Excise Tax Act* requires a vendor of real estate to collect GST unless the purchaser is registered for GST purposes (for most types of sales). Generally, purchasers who sell taxable goods and services can recover GST paid on real estate purchases by registering before closing, then self-assessing and claiming input tax credits. They do not pay GST, nor are the vendors required (or able) to collect and remit GST. Lawyers should note that the Act requires such purchasers to be *registered*, not *registrants*. However, they are commonly referred to as "GST registrants," and we use that term in the descriptions below. The concept is a trap for lawyers, with a number of triggers.

The first is the GST registration process itself:

- *A lawyer allowed a purchaser client to sign the GST registrant certificate when, in fact, it had not yet taken the necessary steps to become a registrant.*

Lawyers also get caught wrongly assuming that a party is – or is not – a GST registrant:

- *A lawyer acted for a vendor selling property that was listed at a certain price, plus GST. The purchaser advised that it was a GST registrant and provided a GST registration number, so the lawyer did not include GST in the purchase. In fact, the purchaser was not a GST registrant and had no valid certificate.*

- *A lawyer for a vendor relied on the purchaser's GST certificate and did not collect GST. The purchasers were not registrants, but the lawyer relied on other lawyers and notaries whose clients appeared to have lied to them.*



- *A lawyer acted for purchasers who paid GST that the vendors remitted to CRA. In fact, the purchasers were GST registrants who should not have paid the GST to the vendors. CRA could assess the purchasers to pay the tax a second time since they have not discharged their statutory obligation to self-assess or pay the government directly. If assessed, they will blame the lawyer.*

Wrong assumptions can also lead to problems when the vendor is not resident in Canada. In that case, the purchaser must pay the GST directly to CRA, regardless of its registration status. Failing to do so leaves the purchaser open to assessment.

The GST registrant status of one party can also distract a lawyer from digging further:

- *A lawyer acted for a vendor selling commercial real estate and the purchaser took title as bare trustee for another company that acquired the beneficial interest. As the purchaser was a GST registrant, no GST was collected. The vendor was later reassessed for failing to collect and remit GST as the lawyer had overlooked that it is the beneficial owner as opposed to that holding bare legal title that must be a GST registrant.*

And finally, timing can be everything when it comes to GST registration. In corporate reorganizations, for instance, the "newco" acquiring taxable assets may have no right to recover applicable GST if it registers after the transfer.

Tips

- As noted, the purchaser must be GST registered. It is not enough for the purchaser to be a GST registrant because

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this includes people who are required to be registered but are not registered. And it is not enough simply to accept the purchaser's provision of a number. You must be satisfied that it is valid on the closing date. If you act for a vendor:

- Obtain the purchaser's GST number and confirm that the purchaser is registered under the number on CRA's website (www.cra-arc.gc.ca/esrvc-srvce/tx/bsnss/gsthstrgstry/menu-eng.html). Print the confirmation for your file.
- Obtain a Certificate of GST Registration Status signed by the purchaser.
- Don't mistake the CRA business number for a GST registration number. While the nine-digit business number is the root of the GST registration number, a person is not registered until the GST account has been activated under the business number, and the suffix RT0001, RT0002, etc. is added to the number.
- Don't assume. One lawyer who failed to determine that the purchasers were GST registrants and could have self-assessed said, "clearer client communication could have helped avoid this mistake." See the tips above to avoid communication breakdowns.
- And if you do make a mistake and the transaction proceeds on the basis the purchaser was GST registered and it was not, **report to us immediately**. Not only are you obliged to do so, but we deal with very experienced counsel who may be able to rectify the matter.

Trap: Not clearly passing the GST buck

Sometimes, a lawyer is targeted when a problem develops out of a GST matter that the lawyer understood the client or the client's accountant was handling. For example:

- *A lawyer acted on a mortgage transaction. The borrower was buying out his partners in a property and part of the deal was the transfer of an interest in another property. The parties were handling the matter of GST themselves, thinking they would not have to pay any. In fact, they*

did, and may turn on the lawyer for not providing them with proper advice.

- *A lawyer acted for purchasers who were denied a GST rebate because one of the purchasers did not occupy the property as a primary residence. The lawyer had assumed that the clients were dealing with the rebate issue themselves.*
- *A lawyer acted for a group of companies in relation to a mixed residential and commercial development. The clients' accountants created the corporate structure pursuant to which the project would be completed, and various GST issues have now arisen. The lawyer may be at risk for not clearly confirming that the GST issues fell entirely to the accountants, and that he was simply following their direction.*

Tips

- Appreciate that, if something goes wrong, you may be targeted simply because, as one lawyer noted, "my client got audited for GST and simply 'needed' someone to blame for the audit." Help us defend you. Be very clear with your client about what you are and are not doing, and confirm it in writing. At a bare minimum, keep notes of advice to your client.
- Remember that if your client has asked you to advise on "tax" – the term covers not only income tax, but GST and the myriad of other federal and provincial taxes imposed in Canada.
- A comprehensive interim reporting letter clearly defines the scope of your retainer and alerts clients to potential problems of which they might not be aware.
- If accounting advice is required, say that and, if appropriate, help your client by offering some choices of accountants (with appropriate disclaimers). Set out clearly in your retainer letter what each professional is doing, and confirm your understanding with the accountant.

Trap: Dropping the GST ball

In many reports, the lawyer knows exactly what needs to be done in terms of the GST

issue but somehow a step is overlooked. For example:

- *A lawyer acted for the vendor of a hardware store business. The parties agreed there would be no GST payable, a permissible election in the circumstances. However, the lawyer never noticed that the purchaser forgot to provide an election form. CRA is now seeking payment of GST, and the vendor is claiming against the lawyer.*
- *A lawyer assumed that a purchaser had a GST registration number and would provide the usual certificate. It seems that the issue completely slipped the lawyer's mind, and neither a certificate nor number was provided.*
- *A purchaser was entitled to a GST rebate, but her lawyer missed the deadline for filing the rebate application.*

Tips

- The invaluable checklist. Not only do checklists make practice more efficient and economical and ensure you take all necessary steps, they are useful for confirming advice and instructions. (An unhappy client's memory may be selective.)
- Use firm-wide systems for limitations and deadlines so required steps are taken in a timely manner – see tips 1 through 22 in *Beat the clock: Timely lessons from 1600 lawyers* (available on the Law Society's website: see Insurance / Specific Practice Risks). And recognize that, because the GST ball might be in the other side's court, you may need to track it there as well. For example, if you act for a vendor on a deal in which the parties have elected not to pay GST, the purchaser needs to file the election form and on time. Otherwise, your vendor client can be assessed for the tax.
- Appreciate that work and personal circumstances may make you more susceptible to oversights. Don't procrastinate, and seek help if you need it. And if you cannot take care of the matter because of workload, personal stress or any other reason, transfer the file to someone who can.