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Mr. John Sitka
Director - General Operations and Border Issues Division
Canada Revenue Agency
Excise and GST/HST Rulings Directorate
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Dear Mr. Sitka:

Re: Revised GST/HST Policy Statement P-051R2
Carrying On Business In Canada

We write on behalf of the Sales and Commodity Tax Section of the Canadian Bar Association (CBA Section) to comment on the Revised GST/HST policy statement P-051R2 *Carrying On Business In Canada* (Revised Policy Statement). The CBA Section appreciates the opportunity to provide its input.

I. Introduction

The Revised Policy Statement attempts to bridge both traditional and e-commerce carrying on business concepts that began with the Electronic Commerce Discussion Paper and the follow-up Technical Bulletin on Electronic Commerce. This is certainly needed and we also commend the CRA for providing numerous examples in the Revised Policy Statement to illustrate situations where non-residents are, or are not, carrying on business in Canada. The rationales provided in the examples help in understanding the CRA's perspective.

The CBA Section outlined its concerns by letter dated March 7, 2002 with respect to the new "place of operations" test for determining whether a non-resident is carrying on business in Canada in the Electronic Commerce Discussion Paper. Our Section was concerned, in particular, that the new test was contrary to established jurisprudence on the meaning of "carrying on business" and recommended that this matter be discussed with the Finance Canada for purposes of amending the *Excise Tax Act* (the Act).

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II. Revised Policy Statement is a Further Departure from Established Jurisprudence

The Revised Policy Statement is a further departure from the extensive income tax jurisprudence on the issues of carrying on business in Canada.

Under the common law test for carrying on business, courts have traditionally placed significant weight on the place where the contract in question is made and, and more recently, the place where the company's profit-making apparatus is located. Courts have also considered numerous other factors to determine if the total business activities of the person are sufficient to constitute the carrying on of a business in a particular jurisdiction.

This jurisprudence was previously accepted by the CRA in Policy Statement P-051R. Policy Statement P-051R emphasized the place of contract and the place where the operations from which profits arise take place, and reiterated that these factors "are the most predominant factors that courts have considered when determining whether a business is carried on in a particular place." Policy Statement P-051R then provided a list of other factors that were nearly identical to those that have been considered by the courts.

All references to existing jurisprudence have been removed in the Revised Policy Statement. This case law will continue to be relevant, notwithstanding the proposed changes in administrative policy set out in the Revised Policy Statement. Amendments to the Act will be required if the intent is to replace the current common law tests for carrying on business.

As noted by Steven D'Arcy,[1] the Revised Policy Statement downgrades the importance of the place of contract and the location of the profit-making apparatus by listing them as part of 12 factors to consider.[2] The Revised Policy Statement also uses the phrase "profit-making apparatus" to refer to the location of the physical assets or inventory of goods of the person. This is not the context in which the courts have used the phrase. Courts have used the phrase to examine the location of the infrastructure used to carry on the business (e.g., location of the managers of the company, employees, location where decisions of overriding importance are made, any manufacturing facilities, offices.).

Moreover, the Revised Policy Statement introduces a new factor (the place where purchases are made or assets are acquired) and substantially expands another factor (the place where agents or employees of the non-resident are located).[3] The courts and the CRA itself in the prior Policy Statement P-051R have looked to the existence of any agents or employees authorized to transact business on behalf of the non-resident person in question and only focused, correctly, on dependent agents. The Revised Policy Statement focuses on the location of agents or employees of the person, regardless of whether they are authorized to transact business on behalf of the person. This represents a substantial expansion of the condition.

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1 "Attempting to Create New Law: The CRA's Draft Policy Statement on Carrying on Business," *GST Monitor* 193, October 2004.

2 If the CRA is relying on case law to support this 12 factor test, it would be helpful to have this case law cited in the Revised Policy Statement.

3 *Supra* note 1.

There should be little doubt that a non-resident actively purchasing and selling or leasing assets in Canada (i.e., by soliciting and concluding contracts in Canada, with supporting business apparatus) would be carrying on business in Canada in most circumstances. However, with respect, the CRA appears to be equating mere physical receipt or physical delivery of property with acquiring and disposing of property. The concepts are fundamentally different at law. We are not aware of any jurisprudence that suggests that mere physical receipt or physical delivery of goods in a jurisdiction is sufficient to result in carrying on business in that jurisdiction.

Examples 16 and 17 in the Revised Policy Statement, which deal with the supply of services by a non-resident, also consider a factor that is not even enumerated as being part of the 12 factors. This new factor is described in the rationales for the foregoing examples as "the relative significance of the service to the overall business activity of the non-resident".

The cumulative effect of the CRA's proposed approach in the Revised Policy Statement is to substantially broaden the factors used to determine whether a person is carrying on business in Canada. This is particularly true with respect to non-resident lessors.

III. Low Nexus Threshold Proposed for Non-Resident Lessors: Place of Supply or Drop-Shipment Rules Ignored

The first six examples in the Revised Policy Statement deal with leasing tangible personal property or real property in Canada. These examples make it clear the CRA intends to expand the basis upon which non-resident lessors will be considered to be carrying on business and thus, be required to register for GST purposes. The CRA relies on paragraph 136.1(1)(a) in this respect[4], but paragraph 136.1(1)(d) of the Act makes it clear that section 136.1 is not applicable to the carrying on business test in section 143. The Technical Notes issued by the Minister of Finance when section 136.1 was added to the Act clearly state: "it is not intended that this separate-supply rule apply for the purpose of determining whether the entire supply is considered to be a supply made in Canada or outside Canada in the first place."

The first and fourth examples in the Revised Policy Statement are particularly problematical as they set a very low threshold or "nexus" test for determining whether a non-resident is carrying on business in Canada. A non-resident lessor need only acquire legal title and have equipment drop-shipped under a lease arrangement to a lessee in Canada in order to be regarded by the CRA as carrying on business in Canada without any other connection to or with Canada. The purpose seems to be to ensure tax is collected. However, there is no need to expand the carrying on business test as the place of supply or drop-shipment rules (section 179) cover the situations and lead to the right result.

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[4] The paragraph deems a lessor to make a separate supply of the lease property for each lease interval. The CRA seems to believe that by making a number of separate supplies in respect of leased property that was delivered in Canada and is being used in Canada, a non-resident lessor is carrying on business in Canada because of the regular nature of the deemed separate supply, but paragraph 136.1(1)(d) clearly states this is not the purpose or use of the provision.

i. Example 1-Lease of Tangible Personal Property

The first example concerns a sale-leaseback situation involving a non-resident lessor and Canadian lessee. Pursuant to the terms of the sale-leaseback agreement, delivery of the conveyance sold to the non-resident lessor occurs in Canada. The Canadian lessee also has physical possession of the conveyance when the agreement is concluded.

The CRA concludes that the non-resident lessor is carrying on business in Canada since the profit-making apparatus (the conveyance) is based in Canada during the term of the lease (given that the conveyance was delivered over to the lessor and lessee in Canada). The CRA reaches this conclusion notwithstanding that: (i) the sale-leaseback agreement is concluded outside Canada; (ii) the non-resident has no employees in Canada; (iii) payments are made to the non-resident outside of Canada; (iv) the non-resident does not have a bank account in Canada; (v) the non-resident is not listed in a directory in Canada; and (vi) the non-resident does not solicit orders in Canada.

The first example effectively neutralizes the drop-shipment rules under section 179 of the Act from ever applying to sale-leaseback transactions (given that the drop-shipment rules only apply to non-residents who are not GST registered). Whether or not this is the intent of the CRA, it is clear that there is a disconnect between the drop-shipment rules provided in the Act and the CRA's new carrying on business test as it applies to non-resident lessors.

ii. Example 4-Assignment of Lease

The fourth example in the Revised Policy Statement concerns the assignment over of a lease agreement and title to the underlying leased property (i.e., equipment) from the original lessor, a resident registrant, to a non-registered, non-resident person. Pursuant to the terms of the original lease, possession of the equipment was given to the lessee in Canada. Title to the equipment is then conveyed to the new lessor in Canada, but the lessee retains possession. The CRA concludes that the non-resident lessor is carrying on business in Canada for essentially the same reasons as in the first example, notwithstanding that: (i) the lease assignment agreement is concluded outside Canada; (ii) the non-resident has no employees in Canada; (iii) the non-resident does not have a bank account in Canada; (iv) the non-resident is not listed in a directory in Canada; and (v) the non-resident does not solicit orders in Canada.

The CRA reaches the opposite conclusion in the fifth example. The fifth example concerns the renewal of a lease agreement where the leased equipment is in the possession of the lessee at its facilities in Canada. The only real difference between the fourth and fifth examples is that in the fifth example, the leased property was originally delivered outside of Canada at the beginning of the lease and thus was subjected to Division III tax at the time of importation. However, the normal place of supply rules or the drop-shipment rules in subsections 179(4) and (2), in conjunction with section 217 of the Act, should apply in Example 4 to ensure tax is exigible or that there is no tax leakage and the right result is reached. A drop-shipment certificate is provided or tax is exigible on the sale to the non-resident. The effective drop- shipment of the leased equipment in Canada to a lessee is not a sufficient nexus for carrying on business in Canada, particularly where the non-resident lessor has no other presence in Canada. The CRA should not try to require such lessors to

register for GST purposes since the CRA has little control over such non-resident lessors and, in any event, this will discourage such lessors from operating in Canada or, if they do, from buying the assets in Canada.

IV. Example 11-Drop-Shipment Rules Applicable for Commercial Services

Example 11 concerns a non-resident who acquires raw materials from Canadian suppliers that are to be shipped to a Canadian resident manufacturer for further processing into finished goods. The non-resident then intends to draw on the finished inventory located at the manufacturer's premises to fill both domestic and export sales orders.

As in Examples 1 and 4, the drop-shipment rules provided in section 179 of the Act should apply to eliminate the GST on the acquisition of the raw materials by the non-resident and the commercial services provided by the manufacturer to the non-resident in respect of the raw materials. Example 11 would prevent the non-resident from benefiting from these drop-shipment rules, given that the non-resident would effectively be required to register for GST purposes. There should not be any concerns regarding tax leakage because if a drop-shipment certificate is not provided, subsection 179(1) of the Act would trigger tax.

V. Recommendations on Examples 1, 4 and 11

Our Section recommends that examples 1, 4, and 11 be deleted or amended to reflect the scheme of the Act. There seems to be discontinuity between the legislated drop-shipment rules in section 179 of the Act and the Revised Policy Statement. Examples 1, 4 and 11 cross the line of not carrying on business in Canada and are not supported by the jurisprudence. There is no need to try to force registration to have the non-resident collect tax when there are rules (section 179 or 142) that already cover the situation. The CRA's conclusions are inappropriate and nullify the usefulness of these rules. The CBA Section suggests that either the text conclude that in these circumstances the non resident is not carrying on business in Canada (while noting that other rules apply), or these examples be eliminated altogether.

VI. CRA's Rationale Provided in Examples Should be Expanded

The 18 examples in the Revised Policy Statement help in our understanding of the CRA's perspective. Where possible, the CRA should expand the rationale section provided so that the example listed can be better applied to a broader range of actual situations for which practitioners will be asked to give advice.

Example 8 is similar to Example 7, but introduces three new facts: (i) the non-resident solicits orders through an independent sales representative, in addition to advertising; (ii) the non-resident maintains an inventory of existing goods for sale at a warehouse in Canada; and (iii) upon receiving orders outside Canada, the non-resident arranges to have the goods shipped from the warehouse to the customers in Canada. The CRA concludes that the non-resident in Example 8 is carrying on business in Canada because "the non-resident has an inventory of goods for sale in Canada, the goods are delivered in Canada, and the non-resident solicits orders in Canada." In Example 7, the opposite conclusion is reached by the CRA because the non-resident only delivers goods in Canada and solicits orders in Canada through advertising.

It is not clear how the two examples would apply to factual situations that fall in between the two scenarios. Is it the warehouse in Canada or the presence of the independent sales representatives that causes the non-resident to be carrying on business in Canada? For example, assume a non-resident delivers goods in Canada and solicits orders through advertising as well as through independent sales representatives, but does not otherwise have any other presence in Canada. It is not clear if Example 7 or 8 would govern. The rationales in Example 7 and Example 8 do not indicate if it matters how the non-resident solicited orders (i.e., through advertising or independent sales representatives).

Many examples would be more helpful if the CRA were to expand the rationale section to also discuss slight variations in facts once the main decision is discussed:

- A paragraph could be added to the rationale section of Example 13 to discuss whether the CRA's conclusions would differ if the Web site owned by the non-resident were stored on a server outside Canada.
- The rationale section of Example 15 could also be expanded by adding a paragraph to discuss whether the CRA's conclusions would differ if the contract called for the non-resident to enter Canada and perform services for longer periods (e.g., 2 months, 6 months) rather than one week.

The foregoing are our preliminary comments. We will continue to monitor progress of the Revised Policy Statement and welcome further opportunities to assist the CRA in any refinements.

Yours truly,

(Original signed by Trevor M. Rajah, on behalf of Allan J. Gelkopf and Dalton Albrecht)

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