April 28, 2006

Jim Daman
Director, Sales Tax Division
Tax Policy Branch
Finance Canada
140 O'Connor Street
Ottawa ON K1A 0G5

Dear Mr. Daman:

Re: November 17, 2005 Legislative Proposals and Draft Regulations — Goods and Services Tax

I am writing on behalf of the National Sales and Commodity Tax Section of the Canadian Bar Association (the CBA Section) to comment on aspects of the draft GST legislation (the Draft Legislation) released on November 17, 2005.

The CBA is a national association representing 35,000 jurists across Canada. The Association's primary objectives include improvement in the law and in the administration of justice. Members of the Sales and Commodity Tax Section comprise experts is all aspects of this area of law.

Our concerns relate to the closely related group election and the retroactivity of other proposed amendments. References are to the *Excise Tax Act* unless otherwise indicated.

CLOSELY RELATED GROUP ELECTION

We welcome Finance Canada's decision to correct a technical problem with the application of section 156 to accommodate income-tax-deferred transactions involving new corporations. The CBA Section has long been advocating to the Canada Revenue Agency (CRA) and Finance Canada to change either the administrative policy and practice, or the law, to facilitate such reorganizations. The backgrounder to the Draft Legislation contains the following comment:

> The second proposed amendment facilitates corporate reorganizations where, in order to comply with the requirements of the Income Tax Act, a corporation transfers assets to a newly incorporated subsidiary in the first step of realizing an income-tax-free reorganization. The proposed amendment will allow the election under section 156 to be used in the case of these reorganizations so long as the transferred assets are used exclusively in commercial activities before and after the reorganization.

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The problem with the closely related group election lies in the definition of "specified member" in subsection 156(1), and particularly in the eligibility test based either on the nature of the property of the member, or on the nature of the "supplies made" by the member. The election does not operate properly whenever there is a transfer of property or services to a newly created corporation or partnership. The technical problem is that, in general, immediately before the transfer, such an entity will not yet own any property, nor will it have made any supplies.

This problem arises regardless of whether it is intended that the newly created corporation or partnership continue to exist indefinitely after the subject transfer occurs. CRA insists that the test in the definition of "specified member" based on "supplies made" is strictly an historic test. In other words, CRA's position is that the reference to "supplies made by a person" is incapable of being read as a reference to the type of supplies to be made in the course of the new person's business once it begins to make supplies.

The Draft Legislation attempts to correct the deficiency with section 156 by introducing the concept of a "temporary member" of a qualifying group. Unfortunately, the definition of "temporary member" has been made unduly restrictive. As a result, the definition will not cure the chronic problem faced by Canadian business whenever internal corporate reorganizations are undertaken. The combination of paragraphs (f) and (h) effectively restricts the "temporary member" of a qualifying group to a new subsidiary corporation incorporated for purposes of completing a tax-deferred "butterfly" transaction contemplated by paragraph 55(3)(b) of the *Income Tax Act*.

However, the technical deficiency with the section 156 election arises in every internal corporate reorganization involving new partnerships or corporations, not just those qualifying as a butterfly transaction described in section 55 of the *Income Tax Act*. In our view, there is no policy reason to limit the amendment to section 156 to butterfly transactions.

The most straightforward approach to addressing the fundamental problem would be to amend the existing definition of "specified member" so that the condition based on the type of supplies made by the member applies to either the historic supplies of the member, or, if the member has not yet begun to make supplies, the supplies intended to be made by the member once it begins operations. A separate clause could address butterfly reorganizations where the transferee corporation may have no taxable supplies, historic or intended in the future. The definition would read as follows:

> "specified member" of a qualifying group means a person that is a corporation or a partnership and
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> (a) that is a member of the group;
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> (b) that is not a party to an election under subsection 150(1); and
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> (c) that satisfies the condition that either
>
> > (i) all or substantially all of its property (other than financial instruments) was last manufactured, produced, acquired or imported by the person for consumption, use or supply exclusively in the course of commercial activities of the person, or
> >
> > (ii) if the person has no property (other than financial instruments), either
> >
> > > (A) all or substantially all of the supplies made by the person are taxable supplies, or, if the person has not yet made any supplies, all or substantially all of the supplies intended to be made by the person are taxable supplies, or

(B) the person intends to receive a supply of property made in contemplation of a distribution made in the course of a reorganization described in subparagraph 55(3)(b)(i) of the *Income Tax Act* from the distributing corporation referred to in that subparagraph that is a qualifying member of the group.

This approach would achieve the desired objectives without introducing new concepts into section 156, which currently is relatively well understood in its present form. By amending the definition of "specified member" as we suggest, the deficiency in section 156 should be cured for internal reorganizations involving new corporations and partnerships. In our view, such modifications are entirely consistent with the policy expressed in the backgrounder to the Draft Legislation.

RETROACTIVE LEGISLATION

The Canadian Bar Association has previously registered its strong concerns over the use of retroactive legislation, particularly in the context of a transaction-based tax such as the goods and services tax. The efficient operation of the Canadian economy demands that businesses and individuals be able to ascertain the state of the law, and thus the consequences of their decisions, at the time they make those decisions.

We have serious concerns with the apparent lack of regard for the need for taxpayer certainty reflected in the proposed retroactivity of certain amendments in the Draft Legislation.

1. Debt Collection Services

In the amendment to the definition of "financial service", the Draft Legislation proposes to "clarify" that debt collection services are taxable for GST purposes. The backgrounder states that this proposed amendment is to "reaffirm the longstanding policy intent".

As with other cases we have seen in the past, Finance Canada appears to be relying on its "clarifying" characterization to justify the use of retroactivity. The Department says that the law was well understood and administered in a consistent manner and, as such, the rules are not being changed after the fact. However, it is increasingly apparent that there is frequently a significant misunderstanding on the part of the Department as to what, exactly, affected taxpayers understood, let alone the degree to which any alleged understanding can be attributed to all, or even the majority of, taxpayers within a given affected industry. Indeed, as tax professionals who deal with taxpayers on a daily basis, we find that very little about the GST, especially as it applies to the complex area of exempt services, legitimately can be said to be clear and well understood by taxpayers generally.

With respect, the appropriate test should not be the "longstanding policy intent" but, rather, the clarity of that intent under the legislation prior to the proposed "clarifying" amendment. Two recent cases, *Royal Bank of Canada v. The Queen*[1] and *Les Promotions D.N.D Inc. v. The Queen*[2], demonstrate that the issue of what constitutes "arranging for" financial services remains unsettled. The latter case in particular reveals the extent to which even the revenue administrators have been uncertain as to the scope of the exemption.

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1 2005 T.C.C. 802.

2 2006 Carswell Nat. 147 (T.C.C.).

In *Les Promotions D.N.D.*, Revenue Quebec initially advised the industry association to which the taxpayer belonged that the services in question did not constitute exempt “arranging-for” services. The taxpayer acted on that interpretation, charging tax and claiming input tax credits. The revenue authorities subsequently changed their position, without advising the industry. The taxpayer was assessed and denied its input tax credits on the basis that it was providing an “arranging for” service. This case reveals that not even the revenue authorities can claim to have had a clear understanding of what constitutes “arranging for” a financial service, or where that fine line exists between the exempt service and a taxable administrative service.

The Courts, as well, have struggled with the lack of clarity in the definition of “financial service” in subsection 123(1), particularly as it applies to “arranging for” services. In *Skylink Voyages Inc. v. The Queen,* Justice Archambault expressed the interpretative difficulty as follows:

> In thus acting as an intermediary in the collection of the amount of the credit card slip, does Skylink provide a "financial service" within the meaning of s. 123 of the Act? First of all, I must note that the wording of the definition of that term is far from clear. Even after a number of readings, it is difficult to understand its entire scope. How then can ordinary taxpayers grasp the extent of their tax liabilities?[3]

Although the Court was prepared to take into account the technical notes of Finance Canada, Justice Archambault ultimately considered the better interpretation of the law to be one that appeared inconsistent with the Department’s press release. In reference to his interpretation that the collection service in question fell within the meaning of the exempt “arranging for” financial service, and was not excluded as an administrative service, Justice Archambault said:

> And yet … [his interpretation] does not appear to be consistent with the purpose stated by the Minister of Finance in the backgrounder cited … because the service in question here is a collection service provided by a third party. *However, the text I must apply is that of the Regulations, not that of the backgrounder accompanying the draft regulations.* [Emphasis added.]

Accordingly, taxpayers’ understanding of the law at any point in time is shaped and governed, not only by the explanatory commentary provided by the administrative authorities and Finance Canada at the time of introduction, but also by subsequent Court interpretations of the final legislation. Ultimately, taxpayers have to live with the law as it is written and interpreted by the Courts, even if an interpretation more favourable to the taxpayer was intended and expressed in a press release or administrative document. It should similarly follow that taxpayers should be able to rely on the law as written at the time they make their decisions, even if an interpretation more favourable to the Crown may have been intended.

Moreover, it is not at all clear that it was Parliament’s intention to exclude from “arranging for” services the debt collection services of an agent actively involved in negotiating the terms of collection and termination of the debt instrument (as opposed to simply accounting for payment on behalf of the lender). It is difficult to see any “clear policy” reason why this end point in the financial service cycle should not be exempt.

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3 [1999] G.S.T.C. 119 (T.C.C.), para 28.

Furthermore, the retroactive application of the financial service amendment to transactions entered into, and amounts paid, prior to the announcement of the amendment raises technical concerns in the following two situations.

- First, the amendment is proposed to apply if any amount of consideration becomes due after the announcement date, or is paid after that day without having become due. Accordingly, for example, if under a single agreement for debt collection services entered into January 1, 2000, a single amount of consideration becomes due after the announcement date, it would appear that all amounts paid as consideration for the supply would be affected. The retroactive application of the amendment thus could have the effect of imposing an unanticipated liability on persons who took the position that the services were not subject to tax, based on the law that existed at the time the parties decided to enter into the transaction, and at the times at which amounts of consideration were paid.
- Second, even if all the consideration for the supply of a debt collection service became due or was paid on or before the announcement date, the proposed coming-into-force rules provide that the amendment applies to such payments, unless the supplier did not collect or remit any amount as or on account of tax in respect of the supply, or in respect of any other supply that includes a debt collection service made under the agreement. Here again, if any GST were collected on any component of a supply that included a debt collection service made under the relevant agreement, all amounts payable under the agreement could be subject to GST retroactive to the introduction of the tax.

2. Inter-branch Supplies

In the case of the second set of retroactive draft amendments, the proposed expansion of section 220, which Finance Canada likewise describes as “clarifying”, the contention that the existing tax law was well understood by taxpayers is suspect. Little of a definitive nature was written on the scope of the intended deeming provision, especially with regard to the possible inclusion of employee activities. In our view, the proposed amendments introduce entirely new rules, not just clarifications of existing rules (although the old and new rules may have similar policy objectives). In light of this resort to retroactivity to fill entire gaps in the legislation, the justification of “clarification” no longer applies.

The proposed amendments to section 220 introduce a substantially broader regime for applying GST to the value of labour and other resources shared, or transferred, between a Canadian entity engaged in GST-exempt activities and its foreign branch. The proposed new rules are so complex that, at the time of their announcement, Finance Canada was not prepared to present them in the form of draft legislation, which is expected to be lengthy. Nevertheless, taxpayers are expected to comply with these unseen rules from announcement date forward, as well as retroactively to 1991. Existing section 220, with its four short paragraphs, likely could not have been understood to impose tax as broadly as will the proposed new rules, nor could the CRA have administered existing section 220 as broadly.

This use of retroactivity appears to violate the government’s own principles, laid down before the Public Accounts Committee, that have, until now, governed when the government would resort to retroactivity. The message now being sent with this Draft Legislation is that the proposed amendments to section 220 are justifiably retroactive because they represent what the legislation should and would have provided had it been drafted more precisely 15 years ago, and had the drafters known then what they know now. In our view, this is a blatant misuse of the extraordinary

mechanism of retroactivity. The Department may expect that, in practice, few taxpayers will face assessments under the new rules on a retroactive basis. However, that is not a valid reason to violate the fundamental principle of certainty underlying the efficient operation of the tax system. If it is true that few taxpayers will be affected, then there is no reason not to introduce these amendments on a prospective basis.

Whatever the dollar magnitude of this issue, our greatest concerns are the increasing frequency of the use of retroactivity, and the move away from truly clarifying legislation to conform with a clear and well understood policy. We are seriously concerned that a trend may be developing toward retroactivity becoming the rule, rather than the exception.

We would be pleased to discuss any of the matters raised here at your convenience.

Yours very truly,

(Original signed by Tamra L. Thomson on behalf of Ronald Cheng)

Ronald Cheng
Chair, National Sales and Commodity Tax Section

cc. Ian Bennett, Deputy Minister of Finance