THE CANADIAN BAR ASSOCIATION
L'ASSOCIATION DU BARREAU CANADIEN

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Via email: fin.gsthst2018-tpstvh2018.fin@canada.ca

Phil King
Director General
Sales Tax Division
Tax Policy Branch
Department of Finance
90 Elgin Street
Ottawa, ON K1A 0G5

Dear Mr. King:

Re: Consultations on the GST/HST Holding Corporation Rules

The Canadian Bar Association Commodity Tax, Customs and Trade Section (CBA Section) is pleased to respond to the Department of Finance consultation on the GST/HST holding corporation rules issued on July 27, 2018. We comment on the proposed changes to subsection 186(1) of the *Excise Tax Act (Canada)* (*ETA*). We also comment on the proposals to expand the rules to partnerships and trusts and to change the *related* test.

I. Proposed Amendments to Subsection 186(1) of the ETA

Current Rules are Effective

We believe the current rules are effective and accomplish their goal, namely they allow GST/HST to be removed from the system when operating entities engaged exclusively in commercial activities are held through one or more holding companies.

Courts have adopted a flexible and sensible approach that allows Input Tax Credits (ITCs) to be claimed where a holding corporation incurs taxable expenses in relation to the shares or indebtedness of a related operating corporation engaged exclusively in a commercial activity. In this situation, GST/HST on inputs should be recoverable as a matter of tax policy. That way, the related group of corporations is in the same position as they would be, had the operating corporation incurred the taxable expenses directly, and Canadian goods and services are free of embedded value-added taxes, when marketed domestically and internationally.

Given the current constructive state of the rules, we trust that the rationale for the proposed amendments is to clarify (and not restrict) the existing approach to ITCs for holding corporations. We would appreciate, however, clarification on the rationale for the proposed amendments.

Potential Adverse Consequences of Proposed Amendments

We are concerned that the proposed changes may (inadvertently perhaps) have harmful repercussions on the competitiveness of Canadian businesses.

Where courts have given helpful guidance on the current rules, and applied them broadly in this greater tax policy context, the proposed amendments appear to limit the application of the rules, and introduce more uncertainty, complexity, randomness – and run counter to the tax policy outlined above.

Moreover, the flexibility of the current rules would be lost. The proposed amendments contain onerous tracing requirements and would require tracking of inputs not otherwise required for commercial or tax reasons. The additional administration and related costs associated with this tracking would be significant and unwarranted.

Recommendations to Modify Proposed Amendments

The CBA Section makes the following recommendations to ensure the proposed amendments address the concerns noted above and are properly implemented.

"For the purpose of" versus "in relation to"

There does not appear to be any reason for changing the language of subsection 186(1) from being "in relation to" the shares or indebtedness of a related corporation to being "for the purpose of" the transactions outlined in either subparagraph 186(1)(a)(i) or 186(1)(a)(ii). The same can be said of subparagraph 186(1)(b)(i). While there does not appear to be any substantive difference, the new language could introduce confusion and uncertainty.

If the change is not intended to narrow the scope of ITC eligibility, it would be helpful to clarify this position in the Explanatory Notes. That way, taxpayers, CRA and courts can benefit from clear guidance in applying the amended legislation. If the phrase "for the purpose of" is intended to be narrower (and restrict ITCs that would otherwise be available under current interpretations of subsection 186(1)), we see no policy reason to limit ITCs.

Paragraphs 186(1)(a) to (c) would also introduce an unwarranted and onerous degree of tracking or tracing.

Paragraph 186(1)(b) of the *ETA*

We identify three further concerns with paragraph 186(1)(b) of the *ETA*.

First, if a parent corporation raises money by issuing or selling its shares or debt, the parent would usually temporarily invest these funds, even if over time the money raised is exclusively for the purposes of funding its operating corporations. Due to the time and costs involved, financings would generally be infrequent. Therefore, for practical commercial reality, it is common for at least a portion of the funds to be temporarily invested by the parent corporation until needed in the commercial activities of the relevant operating corporations. A delay in transferring the proceeds would be especially common where a holding company has interests in multiple operating companies, and at the time the capital is raised, has no idea in which operating entities, or at least in what proportion, the capital would be allocated.

In our view, this time lag should not change the fact that the purpose for raising all the money was to fund the activities of these operating corporations. As such, a holding corporation's access to ITC claims should not be restricted. It is overly restrictive and commercially unrealistic to require a parent company to immediately transfer all the proceeds to its operating subsidiaries every time it raises capital, in order to allow the parent company to claim ITCs.

A second concern with paragraph 186(1)(b) is the need to clarify the scope of the term "proceeds". The amount of proceeds transferred to the operating corporation helps to determine what proportion (which could be 100%) of the holding company's taxable costs of financing or raising capital are eligible for ITCs. The proposed changes limit ITCs to the extent that the proceeds raised are transferred to an operating corporation and used by the operating corporation exclusively in the course of its commercial activities.

For this purpose, the financing/capital costs paid out of the money raised should be disregarded in determining the proceeds available to fund the operating corporation. The pool of available proceeds will be limited by these costs. The availability of ITCs on these costs should not be reduced because the holding corporation uses part of the proceeds to pay the costs of raising the proceeds.

Otherwise, the parent corporation could not claim 100% ITCs even if all the net after-transaction cost proceeds were transferred to the operating corporation for exclusive use in its commercial activity. For example, if a holding company raised $1,100,000, but paid $100,000, inclusive of GST/HST, on the costs of raising this money, and transferred the remaining $1,000,000 to the operating company for exclusive use in its commercial activity, then 100% of the GST/HST paid by the holding corporation in respect of the costs should be eligible for ITC claims.

The third concern with paragraph 186(1)(b) is that the commercial activity of the operating corporation should be extended to situations where the operating corporation uses the funding for financial services relating to its commercial activity, such as to pay down its own debt. Had the operating corporation incurred taxable transaction costs to pay down its debt, the operating corporation would be eligible to claim ITCs pursuant to subsection 185(1) of the *ETA*. That is the appropriate proxy for determining the extent of the operating corporation's commercial activity on which to base the holding company's ITC eligibility.

In the Explanatory Notes example, $50,000 of the proceeds transferred to the operating corporation is not considered for use in the operating company's commercial activity because they are invested by the operating company in money market securities (exempt financial services). However, the $50,000 investment in money market securities should be considered part of the operating corporation's commercial activity if the investment is used to finance the commercial activity of the operating corporation. For its own ITC purposes, the operating corporation is considered to be engaged exclusively in a commercial activity, even in the case of related exempt financial services used in the commercial activity. The holding company's entitlement to ITCs should be based on the scope of the operating corporation's commercial activity for ITC purposes (not the narrower definition of "commercial activity" in subsection 123(1) of the *ETA*, without reference to subsection 185(1) of the *ETA*).

<u>Paragraph 186(1)(c) Overly Restrictive</u>

One arbitrary restriction is found in the proposed amendments to paragraph 186(1)(c) of the *ETA*. This paragraph only applies if "all or substantially all of the property of the parent is shares of the capital stock, or indebtedness, of operating corporations of the parent". There is no policy reason to limit eligibility for ITCs to a "pure holding company" and not allow the ITCs where the holding company has a direct commercial activity of its own.

Based on the CRA's administrative policy, "all or substantially all" means 90% or more.[1] If 70% of a holding company's property related to the shares or indebtedness of its operating corporations, but the other 30% was property the holding company used directly in its commercial activity of making taxable supplies of property management services for fees, all of the property of the holding company should be considered to be used in the holding company's commercial activity. The fact that the shares or indebtedness of the operating corporations is less than "all or substantially all" of the holding company's property in this case should not limit the ITCs available.

It should also make no difference if the operating vehicle engaged exclusively in a commercial activity, and in which the holding company has an interest, is a partnership or a trust. The rationale for allowing the holding company's ITCs remains the same. This point is equally applicable in the next section of this submission on why the holding company ITC rules should be extended beyond corporations to partnership and trust structures.

To avoid these arbitrary restrictions, there would be an incentive to establish a holding company, partnership or trust outside Canada that holds shares or interests in entities engaged exclusively in a commercial activity in Canada (or outside Canada, as in *Miedzi Copper Corp. v R*).[2] That way, the non-resident holding company/entity could obtain GST/HST relief on business inputs acquired in Canada through the zero-rating export provisions and avoid the arbitrary ITC restrictions. It is bad tax policy to encourage investors to establish investment vehicles outside Canada (or put another way, discourage them from establishing their investment vehicles in Canada).

We recommend, therefore, that the threshold of "all or substantially all" of properties held by the holding company in proposed paragraph 186(1)(c) be revised to include property used by the holding company in its own commercial activities *and* interests in all types of operating vehicles engaged exclusively in a commercial activity (e.g., operating partnerships and trusts).

II. Proposals for ITC Holding Corporation Rules

ITC Holding Corporation Rules should be Extended to Partnerships and Trusts

Again, the ITC holding corporation rules should be extended to other types of investment vehicles such as partnerships or trusts. The rules should not favour one particular structure (corporate) over another (partnership or trust).

The arbitrary and unfair denial of ITCs is most dramatically illustrated in the following case of a partnership structure engaging the proposed investment limited partnership rules. Where an "investment limited partnership"[3] (the ILP) is the sole limited partner and has a 99.99% interest in an operating limited partnership (the OLP) that directly owns commercial real estate and is engaged exclusively in a commercial activity, the ILP would pay GST/HST on the fair market value of any administrative or management services supplied by the ILP's General Partner (GP1), an Ontario corporation (which holds the other .01% partnership interest in the OLP).[4]

Let's assume that the ILP wholly owns the Ontario corporate General Partner of the OLP (GP2) and all of GP1, GP2, the ILP and OLP are ultimately owned by the same Canadian company. As such, all of GP1, GP2, the ILP, the OLP and the ultimate Canadian parent company are closely related Canadian

[1] Courts have been more flexible in interpreting this phrase and look at the particular circumstances.

[2] [2015] G.S.T.C. 15 (TCC).

[3] As proposed to be defined in ss. 123(1) of the ETA by way of the draft February 27, 2018 legislation.

[4] Proposed amendment to subsection 272.1(3) of the ETA and addition of subsection 272.1(8) of the ETA by way of the draft February 27, 2018 legislation.

partnerships and corporations (in the same closely related group) within the meaning of subsection 156(1.1) or (1.2) of the *ETA.*

The purpose of these rules is to put the ILP in the same position as other investment vehicles, insofar as incurring GST/HST on their administrative or management services. Yet despite the ILP being closely related to the OLP and the OLP being engaged exclusively in a commercial activity, the GST/HST payable by the ILP to GP1 on the fair market value of GP1's administrative or management services are not recoverable by ITC claims pursuant to section 186 of the *ETA* (either under the current version or as proposed to be amended) or subsection 272.1(2) of the *ETA.*

In this scenario, the ILP should be allowed to claim ITCs to be put on an equal footing with a holding company that would be entitled to ITCs had its incurred taxable costs in relation to the shares or indebtedness of a wholly-owned subsidiary engaged exclusively in a commercial activity (such as owning commercial real estate and making taxable supplies of the property by way of lease or sale). It is simply a matter of tax fairness. That is one of the Department of Finance's objectives for the proposed ILP amendments, and the ITC rules in section 186 of the *ETA* should fulfill this same objective.

Related Test

There is no reason to restrict the ITC holding corporation rules to corporations that are "closely related", as opposed to the current test of "related" parties. Because the holding company's ITCs are generally limited to the extent that the inputs are acquired in relation to the shares or indebtedness of the related operating corporation, the inputs can truly be said to be incurred for the purpose of the related operating corporation's commercial activity and linked to that commercial activity. Limiting the ITCs to a holding company *closely related* with the operating corporation would unfairly and unduly restrict the availability of the ITCs for holding companies.

As we expect that additional challenges will come to light as more practitioners and businesses review the proposed amendments, we will endeavour to provide these examples.

We would be pleased to discuss our comments at your convenience.

Yours truly,

(original letter signed by Marc-André O'Rourke for Robert G. Kreklewetz)

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Chair, CBA Commodity Tax, Customs and Trade Section