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Drop Shipment Rules

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This article provides background on the GST Drop Shipment rules, and discusses CRA's evolving interpretation as to the types of scenarios that may not fall within the drop shipment provisions, as well as those that may create a requirement for non-residents to register for the GST.

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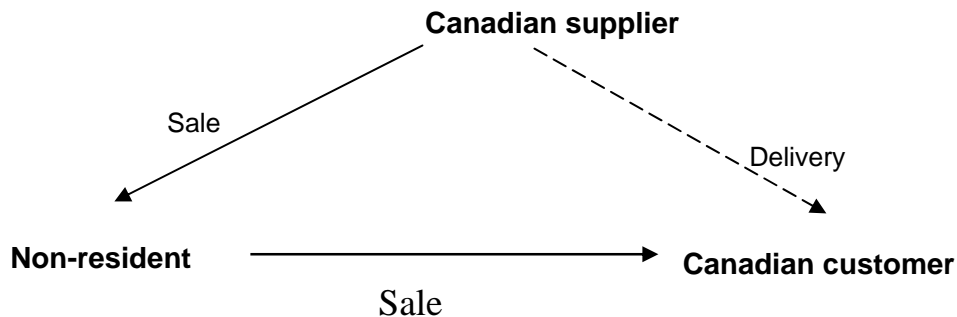
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Drop Shipment Rules

The GST drop shipment rules generally (1) provide an anti-avoidance rule requiring GST to be charged and collected on the FMV of goods sold to a non-resident and delivered to a third party in Canada, and (2) provide relief if the goods are ultimately exported or used by a GST registrant exclusively in commercial activities. Take the simple scenario of a non-resident who purchases goods from a GST-registered Canadian supplier, and arranges for the goods to be delivered directly to its Canadian customer. Subject to GST relief under the drop shipment rules, GST applies on the goods' FMV on their supply to the non-resident because the goods remain in Canada at all times; the tax is potentially unrecoverable.



In more complex scenarios a number of Canadian suppliers provide the non-resident with goods and related commercial services before the goods are delivered to the non-resident's customer (the consignee). Subject to certain conditions, the drop shipment rules can prevent the application of GST to both the supply of goods by the Canadian vendor and to the related services provided by other suppliers in the chain.

For the rules to apply, the non-resident cannot be registered for GST purposes and thus cannot be carrying on business in Canada. Depending on the specific rule applicable, the consignee may need to provide a drop shipment certificate (DSC) stating its name, business number, and acknowledging that it assumes a potential tax obligation with respect to the goods by taking physical possession of them. As the CRA states in the memorandum, the DSC does not "impose a tax obligation" where there was no such "potential obligation".

The memorandum is extensive, incorporating 46 example scenarios, and while it may not reveal much new material, it is a comprehensive source of information and guidance. The rules' potential retroactive effect is confirmed: if the drop shipment conditions are met, a DSC can be issued for prior shipments and any tax previously collected by the GST-registered Canadian supplier from the unregistered non-resident can be refunded, subject to issuing a debit or credit note, within 2 years of its collection.

One troublesome example involves a Canadian manufacturer's sale of goods to a non-registered non-resident, which resells them to Canadian customer A, which in turn resells to Canadian customer B for its use exclusively in its commercial activities. To simplify matters, the Canadian manufacturer agrees to deliver the goods directly to Canadian customer B. Although this scenario arguably falls squarely within the wording of the drop shipment rules, the CRA says that the supply by the Canadian manufacturer is not relieved of tax by a DSC's issuance.

The CRA gave another troublesome interpretation at a recent CBA/CRA GST Roundtable Q&A. The question was raised of the GST status of a non-registered non-resident that sourced goods in Canada from a local supplier and resupplied them to a Canadian customer by way of drop shipment. The CRA said that if the non-resident also solicited orders for the supply of its goods in Canada, it was carrying on business in Canada, must register, and thus could not rely on the drop shipment rules. The rationale behind the drop shipment rules suggests that a non-resident that purchases goods in Canada for delivery directly to a Canadian customer is not necessarily carrying on business in Canada and required to register. To suggest that soliciting orders in Canada to obtain those Canadian sales is sufficient to trigger a registration requirement and thus eliminate the drop shipment rules' application is a regrettable interpretive evolution.

For more information, please contact the author.