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A Confluence of Uncertainties: The GST and Financial Services

by Michael Firth
PricewaterhouseCoopers LLP

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The application (or not) of GST to discretionary investment management fees, pension fund costs and 'imported services' continues to be problem areas that have yet to see enacted legislation to resolve them. This brief document gives a useful background to the disputes involving the Canadian Medical Protective Association and General Motors, in addition to setting out the difficulties determining what intermediary services are exempt as opposed to taxable. It also contrasts the decline of Canada into more GST complexity around financial services, with the direction of Europe, where the drive is towards certainty and simplicity.

Michael Firth

michael.p.firth@ca.pwc.com

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1. The Big Picture

*“Our feet on the torrents’ brink, our eyes on the hills afar,
We fear the things we think, instead of the things that are.”*

- John Boyle O’Reilly

The financial sector in Canada continues to bear significant costs from the burden of uncertainty when it comes to GST legislation and its administration. In order to put everyday business transactions in place, and especially to deal with the evolutions that are imperative for competitiveness and survival, Financial Institutions (F.I.’s) and those that interact with them currently have to seek much advice. The majority of these uncertainties will ultimately be reduced through the ongoing collaborative efforts of the Canada Revenue Agency (“CRA”), industry representative bodies, and the Federal Department of Finance (“Finance”), although a prolonged and chronic lack of resources at Finance continues to delay statute maintenance, the avoidable costs of which are significant. The most distasteful uncertainty, and one that multiplies the financial perils, is one which, as a persistent feature of the landscape, is largely peculiar to Canada, the Financial Sector, and this tax; harsh retroactive legislative changes, the latest round of which reach back a breathtaking fifteen years.

This brief document, and the presentation that accompanies it, reviews the major areas of change and uncertainty, and looks forward to likely resolutions, in an effort to assist buyers, sellers, and intermediaries that deal with financial instruments and financial services. The objective is to provide the reader with a broad understanding of the structures and transactions that will give rise to a need for advice; not replace that advice, and to make Symposium attendees more astute buyers of advisory services in this area.

Not addressed are issues that reach beyond the financial sector, such as the single/multiple supply test, and the incidental rules. Issues arising from outsourcing are covered in another presentation at this Symposium.

Of keen interest to F.I.’s and their industry bodies will be the current momentum for change in VAT situation in Europe. After years of disputes over the very issue that are current in Canada such as exemption for “arranging for” taxation of administrative services and audit initiatives to carve back recovery of VAT by Financial institutions, the EU Commission has begun a determined effort to ‘modernise’ VAT as it applies to the financial sector, driven by concerns that VAT strictures have stifled merger and other cross-border activities that are necessary for the sector to remain competitive¹.

Having read this document and heard the presentation, stand back and survey the current state of GST affairs in Canada. Compare it with the European environment, where there is an informed pause for reflection on the real and concerning effects of domestic legislation and administration on overall competitiveness of the banking and insurance sectors. You might then agree that the

¹ See an excellent article by Piet Battiau, Chair of the VAT Working Group of the European Banking Federation in the November 2005 edition of The Tax Journal, and visit the FBE website <http://www.fbe.be> under ‘Policy papers/Fiscal affairs’.

Canadian legislative/administrative pendulum has full momentum swinging into the direction of overreach and undue stricture, at precisely the point when the European one is swinging in the opposite direction to a position where the objectives of nurturing the Finance sector and taxing it are being adjusted into a healthier balance. In a number of areas, including the long predicted framework governing recovery of GST by financial institutions, it would seem that Canada is currently on course to repeat mistakes that Europe is already correcting.

2. “Financial service” – the definition:

a) *Discretionary Investment Management Services;*

Discretionary investment management services have been the subject of a number of disputes since the introduction of the GST. This service will be at the heart of at least two more disputes in The Tax Court of Canada before next year’s Symposium. A fairly detailed technical review of the history is worthwhile, to equip you for a fully informed reception of what comes next in this area from the CRA, from the Tax Courts of Canada, and potentially from Finance.

This section concerns itself only with discretionary investment management services. These are distinguished from non-discretionary investment management services by the characteristic that once the investor has set investment parameters for the investment manager, it then has no involvement in the decisions made in relation to the portfolio. The Investment Manager has full discretion to instruct brokers to buy and sell the underlying securities, and the investor only learns of the trades subsequently, when given updates on the performance of the portfolio. By contrast providers of non-discretionary investment management are required to inform and consult the investor on some or all trades, and so this service clearly involves the provision of advice, and is taxable by virtue of being excluded from the definition of an exempt financial service by subparagraph (p) ...” the service of providing advice, ...”. No advice is received by the purchaser of discretionary investment management services, however, and so, provided the role of the investment manager is within the inclusive part of the definition of “financial service” (on which, more later), the service will only be taxable if exclusions other than subparagraph (p) make it so.

Whenever there has been a legislative challenge, successive Canadian governments have mounted a robust defense to include investment management services within the tax base of the GST. There have been challenges by Mutual Funds, Segregated Funds of Insurers, and Pension Funds. It is useful to review each in turn.

i) *Mutual Funds*

Apart from a minor wrinkle surviving for the first eleven months of the GST, Mutual Funds are generally ‘consumers’ in the scheme of the GST, being unable to recover GST borne on costs. In the early 1990s, there was a challenge to the legislative effectiveness of the Excise Tax Act (“ETA”) in applying the tax in the area of financial services. A number of Fund groups filed claims on behalf of funds for rebates, claiming a refund of GST incurred over the preceding four years. These claims were based on an interpretation of the ETA which concluded that investment management services were not taxable when rendered to, among others, Mutual Funds, but rather were exempt, and so GST had been paid in error. Given the size of the industry, and the four year window for rebate claims, the amounts of GST that would have been repayable to the Mutual Funds under this interpretation was a significant sum.

The initial government response was a press release proposing to modify the legislation both prospectively and retroactively, **but** which provided grandfathering for claims filed before the date of the announcement. While a significant number of Fund Managers were aware of the possible interpretation, and had taken action to ensure that Funds under their management had filed claims to vest rights to the refunds, not all Fund Managers and trustees were. Consequently, effective on the date of the Finance announcement, the population of Canadian Mutual Funds was cleaved into two sets: those which had filed claims and stood to receive significant refunds, and those which had not.

Various representations were made to Finance by the affected parties. Representatives of those Funds which had not filed claims would likely have argued to level the playing field, to ensure that Funds which had filed claims would not enjoy a competitive advantage if refunds were received. Given the directly conflicting interests amongst its members, any industry representative organization would be unable to make unequivocal recommendations to Finance.

In response to clamoring for leveling the playing field, Finance had two options to restore parity to the GST treatment of investment management services rendered to Funds in the period before the legislative announcement:

- It could modify the grandfathering to admit claims from all Mutual Funds in Canada for the 4 years before the announcement - an expensive option likely costing in excess of \$500 million if the legislative challenge was successful or
- It could simply strike out the grandfathering to make the legislative amendment utterly retroactive, thereby extinguishing the vested rights of those Funds that had filed a claim relying on the law at the time the claim was filed.

Finance Minister Paul Martin selected the latter option. The legislative amendment was reintroduced on the 23rd of April, 1996 with no grandfathering, i.e. the amendment was modified to make it retroactive in all circumstances.

Before the legislative amendment proposed in April 1996 received Royal Assent, a number of C.I. Mutual Funds (which had made claims for refunds which had been denied by the Canada Customs and Revenue Agency) appealed the decision to the Tax Court of Canada. The case was heard in circumstances where legislation in force when the claim was filed was still extant, but for which a retroactive amendment extinguishing that legislation had been proposed. One significant factor rarely noted in any public commentaries on the C.I. Mutual Funds Tax Court decision is that this decision involved filed claims for recovery of GST paid in error in 1995, ***after the date of the initial announcement from the Department of Finance.*** In other words, the C.I. Funds had filed claims after expiry of the period of grandfathering in the original proposal. One can debate whether the Tax Court was influenced by this fact, but the issue became academic when the Tax Court concluded that in its view, both the pre- and post-announcement versions of the legislation successfully applied the GST to investment management services supplied to Mutual Funds.

Still of interest in October 2006 is one aspect of the government's position in the case, which was that the services flowing from Fund Manager to Fund were taxable by virtue of exclusion from the definition of an exempt "financial service" in this case a particular aspect of the exclusion in subparagraph (q), that was intended to capture Mutual Funds by reference to the fact they invested "on behalf of" others. In other words, the service was readily accepted as being within the inclusive part of the definition, but then the dispute centred on the exclusion. In layman's terms the position was, "It is in, but then it's out under (q)". As you will see that stance has now evolved to, again in layman's terms, "It's not in to start with, but then even if it is in, it's out under (p)".

The government of the day was forced to reconsider the subject of the application of GST to Mutual Fund management services, and it chose to reaffirm the application of GST to those fees, and furthermore was prepared to undergo a significant amount of criticism in the international and Canadian media to do so on a harshly retroactive basis.

ii) Segregated Funds of Life Insurers

The original structure of the ETA sought to put Segregated Funds held by life insurers on a similar footing to Mutual Funds with respect to the amount of GST borne on the activity of managing these Funds. Presumably, the rationale was that even though a Segregated Fund of a life insurer is simply a pool of money used as a basis for valuing a life insurance policy, it functions as an investment vehicle, and should not enjoy a GST advantage over an alternative investment vehicle such as a Mutual Fund.

The initial version of the GST legislation had a number of deeming provisions which were intended to achieve that effect. To describe the mechanism briefly, the GST is a tax on supplies, and given that a Segregated Fund is simply one discrete asset of the life insurer and one can not make a supply to oneself, a fictional supply must be fabricated in order for the tax to be levied. The legislation first deemed a Segregated Fund to be a trust separate and apart from the insurer. It then deemed the insurer to be the trustee of that trust, and finally it deemed the duly-created trust and trustee to be persons dealing not at arms length. A separate deeming rule requires non arm's length parties to remit GST when a supply flows from one to the other if the recipient cannot recover GST. It was contemplated that based on the above set of deeming rules, the insurer would be obliged to remit GST on the value of its management of the deemed trust, i.e. the Segregated Fund. Consequently, GST would be remittable in a similar fashion to that where management services flowed from a Fund Manager to a Mutual Fund.

Whether the ETA successfully delivered this legal result was challenged when a Life Insurer advanced the view that the deeming rules were not sufficiently complete to require remittance of GST. In the case of *Maritime Life Insurance Company*, the Appeal Court confirmed (although for simpler reasons) the Tax Court's view that the ETA did not successfully apply the GST to the value of the insurer's management activity relative to the Segregated Fund. Finance's legislative response to the *Maritime Life* case came on March 16, 1999. The structure of deemed fictions was improved and completed, such that GST would apply prospectively and retroactively. The rigid new structure applies tax in a fashion that allows no consideration of the nature of the supply - it bluntly deems a tax to be payable in certain specified circumstances. Notably however, any claims filed by insurers on behalf of their Segregated Funds asserting that tax had been paid in error, and any situations where tax had not been collected by the insurer, were grandfathered. Even though

the life insurance sector was similarly cleaved into those who had filed claims and those who had not, there appears to have been no pressure for a leveling of the playing field at any cost. The grandfathering survived, and a number of significant rebates were released, the benefits of which flowed through to policyholders.

Significantly, here again, the federal government had the opportunity to reflect on the application of GST to the investment management activity relevant to Segregated Funds, and legislatively reaffirmed the application of the tax after contesting an interpretative challenge to the Appeal Court level. The case was decided on the basis that there was no supply to tax, so there was no opportunity for any decision on whether the nature of the deemed service was within the inclusive part of the definition, or was taxed by an exclusion.

iii) Pension Funds

Pension Funds which are not treated as a limb of a provincial government pay GST on any taxable services they receive, including investment management services.

As in the case of mutual and Segregated Funds, the application of GST to investment management services provided to Pension Funds was subject to challenge. In June 1998, a number of Pension Funds filed rebate claims for tax paid in error, asserting that the legislative provisions applying tax to some investment management services did not tax those provided to Pension Funds. Finance's response to these claims was swift, and on the 29th of July 1998 it issued a press release setting out new legislation which would put the taxation of a wide variety of services rendered to Pension Funds beyond doubt, effective from the date of announcement. Claims filed before the date of announcement were grandfathered, being able to pursue their claims through the Courts and have them adjudicated under the version of the ETA in force at the time those claims were filed. After a lengthy process, the *College of Applied Arts and Technology Pension Plan* received a decision from the Tax Court of Canada, which upheld the view that investment management services supplied to Pension Funds were exempt.

As for the other financial services industries, when the Government was forced to reflect on the application of GST to management services rendered to Pension Funds, it responded swiftly and assertively to enforce taxation.

iv) What next? More disputes, some new CRA angles

Each time the Federal Government's tax treatment of investment management services provided to Mutual Funds, Segregated Funds, and Pension Funds has been challenged, the response has been to firmly defend application of the tax. While we have seen harsh retroactivity in the case of Mutual Funds, there has been grandfathering for those that had evidenced reliance on the legislation of the day by either filing rebate claims or not collecting the tax in the cases of Segregated Funds and Pension Funds.

There have been nuances in each legislative dispute that focused on whether each slightly different service was excluded from the definition of “financial service”. A consistent feature *so far* has been a ready acceptance and agreement that the services were all within the inclusive part of the definition a very broad and inclusive definition especially given subparagraph (l), ...”*the agreeing to provide, or the arranging for, a service referred to in any of paragraphs (a) to (i),*”

Discretionary investment management services will be the single subject service of an upcoming Tax Court case involving *The Canadian Medical Protective Association*, and one of possibly a number of Services considered in another case involving *General Motors of Canada Limited*. The indications are that a radically new view of matters will be advanced. This new view is one that the CRA now offers to any entity that files a claim for a rebate of tax paid in error on discretionary investment management services, because it cannot see reference to itself in the current version of the exclusion in subparagraph (q). This set of eligible filers includes Insurers, corporate entities that are neither investments plans as defined in Ss149(5), nor have investing as their principal activity, and various other charitable and religious organizations and trusts that have a block of capital requiring careful management before being dispensed. It also includes private individuals.

The new CRA view of the ETA context of discretionary investment management services has not yet been set out in published guidance, but a broad sense of the position is that *either*

- Discretionary investment management services are not those of a kind within the inclusive part of the definition of a “financial service” to begin with; *or*
- The *value* of this service far exceeds the value of simple intermediation- the charge that would be levied by a mere broker. The differential quality is the superior investment acumen or expertise of the particular intermediary in this case, and so the overriding characteristic of what is being acquired is effectively investment *advice*. Access to the investment results driven by decisions made by an excellent investment *advisor* is inherently the greatest value element in the relationship, and so somehow it is *advice* conveyed to the investor. Hence the exclusion in subparagraph (p) applies to tax the supply. The *nature* of what is conveyed is somehow changed through a new alchemy of characterization, related to *value*.

These are both novel arguments raised by the CRA, fifteen years into the life of the tax. What problems in trying to advance them? Taking each in turn...

- Discretionary investment management services are not those of a kind within the inclusive part of the definition of a “financial service” to begin with.

The biggest problem with this one is that the CRA’s own Policy Statement P-239 sets out the elements of an intermediary’s behavior that need to be present in order for the role of the intermediary to qualify as “arranging for” the supply of financial services and therefore be exempt. A quick comparison of any typical discretionary investment management agreement (they vary little) to the required elements in P-239 will show that all the elements are present in a solid way. Section 2 (c) of this document examines that Policy Statement in more detail, but suffice it to say it presents one of the narrower views on the scope of the term. If discretionary investment

management is actually outside the scope of the exemption, then things are very much awry across the entire financial sector.

On to the CRA's second argument, the new alchemy.

- The *value* of this service far exceeds the value of simple intermediation- the charge that would be levied by a mere broker. The dominant reason for the value differential is the superior investment acumen or expertise of the particular intermediary in this case, and so the overriding characteristic of what is being acquired is effectively investment *advice*. Access to the investment results driven by decisions made by an excellent investment *advisor* is inherently the greatest value element in the relationship, and so somehow it is *advice* that is conveyed to the investor. Hence the exclusion in subparagraph (p) applies to tax the supply. The *nature* of what is conveyed is somehow changed through a new alchemy of characterization, related to *value*.

The exclusion in subparagraph (p) is simple and literal ... “*the service of providing advice...*”. What advice does the client of a discretionary investment manager receive? When is the client given a block of market information and a set of recommendations and asked to make a decision to buy, sell or hold? It is not. Subparagraph (q) was a decision to exclude from exemption and tax based on the recipient being one of three types of entity having one specified principal activity- for ease of reference let's call them “in (q)” entities. That somewhat exotic and experimental combination was intended to tax a number of entities that it clearly did not, and so one can understand how other targeted entities should be added to the exclusion to try and clarify the way to the originally intended result. Subparagraph (p) is a different matter entirely- it is a clean and simple exclusion by reference to the *nature* of the supply. *Should* a Tax Court be seduced by the ‘alchemy’ argument, then chaos would ensue. Think it through – at what value point would brokerage become advice? Sometimes very significant intermediary fees will be payable to an intermediary for large value transactions on, say, an IPO. There may be no advice in this case related to the actual share transaction, but there is abundant highly valued expertise. Will we be required to delineate which *types* of an intermediary's expertise, access to which will constitute advice?

The treatment of discretionary investment management services is the sole issue in the upcoming Tax Court case involving *The Canadian Medical Protective Association*, and so a decision will address the above arguments, which we can expect to be made much more elegantly than they were here. This service is only one of a number of issues to be addressed in the *General Motors of Canada Limited* case however, so resolution there may be possible without touching on these arguments.

You now have some background to put the upcoming disputes into context. The CRA is developing new arguments not advanced in at least three major disputes when they could have been. Finance has now ‘clarified’ subparagraph (q) a number of times over the fifteen years of the tax, and has not yet achieved a position where all entities purchasing discretionary investment management services are subject to the tax, even though it has been aware since at least June 1998 (when the CRA began receiving refund claims) that Insurers, for example, remain without the exclusion.

What would be wrong with an exclusion that taxed investment and other portfolio management services by name and nature? Nothing. What would be wrong with such an amendment on a totally retroactive nature, possibly announced some two or more years after a taxpayer received a favorable decision from the Tax Court of Canada that it was not subject to the tax? You decide.

On a practical level, what are suppliers and recipients of discretionary investment management services to do? Suppliers should continue to charge and remit the GST as the CRA would tell them they have always been bound to do by the ETA. Should any investors claim the tax is not due, suppliers should offer their client a claim form for a rebate of tax paid error. Intermediaries should also watch the developments in this area very closely, especially the attempted super expansion of the exclusion under subparagraph (p).

b) Management and Administrative services

Management and administrative services are both key terms in excluding significant value from the exemption for financial services, thereby including them within the tax base. Interestingly though, these two terms, each of which can be both broad and vague, have such a critical taxing role, and yet neither one is more fully defined in the ETA. Predictably, that is leading to a variety of views on what the terms successfully subject to tax.

For the financial services area, the terms serve together to exclude a service from exemption under subparagraph (q) of the definition of “financial service” in Ss 123(1), and then “an administrative service” is used alone in paragraph 4 (2) (b) of The Financial Services (GST/HST) Regulations (“The Regulations”), appended to tax services under the paragraph (t) of the definition of financial services. Even beyond these usages, both words have been used with varying success in efforts to characterize a service as not in the nature of a financial service, as if in some way ‘management and administrative’ and the ETA definition of a “financial service” are obviously mutually exclusive sets.

To avoid confusion, it will be best to deal with each usage in turn.

First, consider the terms used together in the exclusion from Financial service under subparagraph (q), inserted here for ease of reference.

(q) the provision, to an investment plan (as defined in subsection 149(5) or any corporation, partnership or trust whose principal activity is the investing of funds, of

- (i) a management or administrative service or***
- (ii) any other service (other than a prescribed service)***

If the supplier is a person who provides management or administrative services to the investment plan, corporation, partnership or trust.

Used here the taxing effect is limited only to those services which are within the inclusive part of the definition of “financial service” and supplied to those entities contemplated by the subparagraph i.e. partnerships corporations or trusts having the required principal activity, and investment plans as defined “in (q)” entities.

The structure of the exclusion makes the analytical exercise a very brief one, because if the supplier supplies either a management or administrative service to an “in (q)” entity, then all other services supplied from that supplier to that entity become subject to tax, subject only to a few limited prescribed exceptions. It is difficult, if not impossible to have a responsible role providing services to “(q) type” entities without incorporating elements of service that are either management or administrative in nature- certainly in the case of fund or portfolio management contracts record keeping, reporting, and other duties related to custody and settlement are clearly spelled out. It is difficult to contemplate any services that might flow to “in (q)” entities that might qualify as a financial service and NOT oblige the supplier to perform some reporting or evidencing tasks that would be administrative in nature – the only finer point would be whether the administrative service were supplied to the entity, or simply a contractual obligation upon the supplier.

Next, what of the exclusion of administrative services by The Regulations? The taxing role of paragraph 4 (2) (b) of The Regulation can be seen in two ways. Either it is something of a safety net to tax some services that would be considered by many to be otherwise exempt as an “arranging for” service, or there simply to tax the purchase of “back office” services by financial institutions that might not have a financial character when considered in isolation in any event - sort of a belt and braces approach. The latter characterization does not hold water, because paragraph 4(3) shelters exactly these services from taxation, retaining the exemption in cases where the supplier has a specified status of a “person at risk” and so on. Again in layman’s terms, “These simple administrative services are in the exemption to start with, because some of them are specifically identified to put them out, and then on top of that, having been identified, some of them have a rule to keep them in the exemption in because of a specific hat worn by the supplier”.

To the extent that administrative services are a subset feeding into a greater supply that qualifies as an exempt financial service, therefore, The Regulations do tax administrative services when the disassembly of the greater supply by subcontracting reaches the point that the primary nature of the service is an administrative, rather than a financial one. The key issue for taxpayers and advisors is at what point in the disassembly of a service used in the course of providing a financial service does tax begin to apply? There is no definitive litmus test that emerges from a study of Canadian cases and rulings at this point. The structure of The Regulations is a fairly common sense guideline, however, as it shelters administrative services using the yardstick of risk to the supplier arising from its relationship to the financial instrument that is subject of the supply. Administrative services will remain exempt if supplied by a ‘person at risk’ defined, ..

“Person at risk”. In respect of an instrument in relation to which a service referred to in subsection (2) is provided, means, a person who is financial at risk by virtue of the acquisition, ownership or issuance by that person of the instrument or by virtue of a guarantee, an acceptance or an indemnity in respect of the instrument, but does not include a person who becomes so at risk in the course of, and only by virtue of, authorizing, a transaction, or supplying a clearing or settlement service, in respect of the instrument.

or by ..

” (b) a person that is closely related to a person at risk, where the recipient of the service is not the person at risk or another person closely relates to the person at risk, or

(c) an agent , salesperson or broker who arranges for the issuance, renewal or variation, or the transfer of ownership, of the instrument for a person at risk or a person closely related to a person at risk”.

Once again even at the bottom of the subcontracting food chain, we come back to the key test of “arranging for” as the delineator (see following Section 2c).

Here is a suggested approach if you think you may be dealing with an administrative service. First, consider if the supplier is eligible for the exceptions under paragraph 4(3) (a) through (c) of The Regulations. If not, then read the contract for the service. Is it primarily for a service that is administrative in nature? Nine times out of ten the answer will be straightforward, because buyers

of administrative services need a high degree of specification around the tasks and price. There are still currently many cases of clear exemption under the exceptions where tax is charged in ignorance of the sheltering in The Regulations. The real difficulty here, and the subject at the heart of most ruling requests in this area, is not whether the service is administrative, but whether the supplier is “arranging for”.

So, in terms of the actual use of the words in the ETA, management twinned with administration in subparagraph (q) seem fairly straightforward because of the broad sweep of ‘management’ to displace or override the exemption of what is initially an exempt financial service. The use of ‘administrative’ alone in The Regulations is not problematic.

By far the greater problem with both words is that they are the basis for a widespread but flawed concept that is alive and well, and featured in much that is written and discussed about the GST. It is the idea that the set of services having management administrative aspects in their nature is a set that is exclusive to the set of services having the nature of a “financial service”. This concept is crystal clear in the CRA’s GST Policy statement P-126, dealing with Intra-company cost allocations by foreign based insurance companies. Examining the situation where a non-resident head office provides a range of support services to a Canadian Branch, some elements of which may be exempt if considered in isolation, the Policy Statement concludes very simply that “If the supply is a single supply, then it is considered a management service and the entire amount would be taxable...”. There is no further detail on why the supply is considered to be a management service, supported by any detail on what attributes distinguish a management from a financial service. The views in P-126 not in harmony with those of the Tax Court in the case of *State Farm Mutual Auto Insurance Company*. In this forthright view on the question of what was the nature of any service that flowed, from a U.S. Head office to a Canadian Branch of the Insurer, the Court took the view that.....

“I have been unable to see in the evidence that any management or administrative services were rendered by the head office to the CRO [Canadian Regional office]. If the services were rendered at all, they related to a supply of financial services as defined in subsection 123(1)”.

Was the “management” nature so absent in the facts here, or was the Crown overly reliant on two assumptions:

- What flows downhill in a corporate hierarchy is by nature “management” (especially given the handy label that it is paid for by management charges), and then, most perilously,
- Anything that is by nature “management” is excluded from being a financial service?

The oft-stated CRA view of the decision in the State Farm Case is that it was largely fact-driven, and so P-126 stands unaltered as a sound policy. If one reflects on this case very carefully, the more correct statement may be that that the result here was heavily *evidence* driven, evidence being a function of selection by the advocates. It is a much more attractive proposition to evidence a very well defined nature target such as the inclusive part of the definition of “financial services”, than it is to displace that very tangible evidential match in the way the Crown attempted i.e. by relying (with scant evidence) on what is in fact an undefined (for ETA purposes), extra-statutory non-exclusion - that of presence of the nature of management or administration. With the benefit

of much hindsight and careful reflection, it now seems that the *State Farm* decision may not be the high water mark on thinking in this area that it was originally heralded to be. To fully illuminate the futility of the exercise engaged in by the Crown in the *State Farm* case, one could say that instead of arguing that the services were not “financial services” because they were management or administrative services, there would have been equal merit in arguing that the services were not “financial services” because they were American in origin, because they flowed away from the equator, or because the dollar values involved contained several threes.

The nature of “management” was commented on more recently in the decision involving *La Banque Canadienne Imperiale de Commerce [2004-1427 (GST)G]*.

There are probably no technical aspects of this horrible decision that do not qualify as a study in misapprehension. Thrown in for good measure, and useful here, only in ascribing the full arc of views on the nature of “management”, is this...:

“management is all about being able to control how a business is run and the collection agencies had no voice in how CIBC ran its business”.

We see two ends of the spectrum in *State Farm* and the *CIBC* case. On the one hand, services are overwhelmingly financial in nature, and any management or administrative services are present in only incidental amounts if at all. Because an intermediary had no say in how the principal issuing the instrument ran *its* business, it could not be said to have a management, as opposed to administrative role over recoverable debts, the instruments that were the subject of its services, even though it had discretion to accept part payment. Do not let the oddness of comments in the *CIBC* case trouble you too much, because you will shortly be invited to agree that both views are wrong.

Here is a practical approach to the topic of “management” and “administrative” services in the area of financial services that, after some reflection, is the only one that makes sense to the writer.

First, the use of these terms together in the exclusion in subparagraph (q) makes that exclusion very broad – perhaps even broader than currently applied by the CRA, to the point of possibly being universal, save only the prescriptions.

Second, the use of “administrative” in The Regulations is not overly problematic; agreements describing the supply are very specific as a function of customer requirements, and the exceptions by status are crisp.

Third, and most significantly, any attempt to demonstrate “management” or “administrative” qualities in a supply, for the express purpose of disapplying the inclusive part of the definition of “financial service” is sadly misguided. Management, administrative and “financial service” as defined, are largely a common set. In the hope of achieving one objective of this presentation, the death and burial of a flawed concept in common currency, this section finishes with a statement, submitted for your consideration as a fundamental truth.

Most, if not all, “financial services” are management and/or administrative services.

c) Exemption of “arranging for”, or intermediary services

In order to avoid distortions between those F.I.’s that outsource intermediation as opposed to performing it in house, the ETA provides for the exemption of intermediary services, principally through subparagraph (l) of the definition of “financial service”,

“(l) the agreeing to provide, or the arranging for, a service referred to in any of paragraphs (a) to (i)..”

European VAT incorporates very similar concepts, in particular the United Kingdom has almost identical wording that exempts “the making of arrangements” for the supply of a financial service.

There is a broad range of published comment and cases on the width or narrowness of the words “arranging for” and a comprehensive study is beyond the scope of this presentation. The scope of the exemption has been commented on at a number of CICA Symposia, and cases on “arranging for” will always be covered in case updates. Here the intention is to stress the need to keep this aspect in view and to provide some distinguishing comments on the Canadian context and experience, with some pointers on common blind spots.

The exemption of intermediary afforded services by this subparagraph absolutely key to much advice given to F.I.’s. Having read the preceding section, you will now see that “arranging for” is likely to be a lasting interpretive challenge, and through the operation of paragraph four of The Regulations, the definition that resolves much concern initially perceived to be about management and administrative services. A brief read of just the Canadian cases will demonstrate that Tax Court Judges can have differing views on the breadth of the exemption, so it is a safe bet that tax advisors probably differ even more widely. Consequently, where the dollars are significant, this is an area where one advisor may not suffice, or at least the taxpayer should verify how much work it’s customary tax advisor has done in this narrow but boggy area. Also, this is an area where recourse to a ruling or legal opinion is going to be more common.

Probably the most shocking aspect of the Canadian experience with this definition is how long the Canadian system survived without detailed CRA guidance, and then, when the process of developing guidelines got under way with the release of a draft of GST/HST Policy Statement P-239 *over ten years* into the life of the tax, how undeveloped the CRA views were, as evidenced by the early drafts.

The final version of P-239 “Meaning of the term “Arranging For” as provided in the definition of “financial service” has been in the hands of auditors for some few years now, and we are seeing more detailed disputes on the definition.

There are a number of simple oversights dealing with the definition that crop up regularly. One is that the term requires a principal *and* an intermediary to apply i.e. you cannot arrange for yourself to supply or receive something; notwithstanding that a payment may be related to a financial service or instrument and be called a “commission”, if it relates to a supply where you are the principal, “arranging for” has nothing to do with it. In other words, you cannot be your own intermediary.

Subparagraph (1) exempts the agreeing to provide OR the arranging for ... (a) to (i). It is a multiple choice, and does not exempt the arranging for the agreement by another party to provide. If you are looking at situations where commitment fees and intermediaries are involved, walk carefully through the definition- it may not cover all intermediary permutations.

European cases, either domestic or at the higher E.U. levels have sometimes taken a very broad view of the European exemption. That is all well and good, but taxpayers and advisors need to look very closely at the CRA Policy Statement and be realistic. The CRA view is quite narrow, and the CRA thinking, as published Rulings show, can be receptive and flexible, is not inclined to stray far from that narrowness. It is not unusual to see a client with a significant assessment relating to a supply viewed by the CRA as taxable in one hand, and a confident opinion of exemption in the other. Unless you have the resolve and funding to litigate, broad European views on Arranging For should be regarded as a little more than a glossy brochure for an unaffordable holiday.

There tends to be a divergence of risk and perceived responsibility when large F.I.'s have a battery of smaller intermediaries competing for their business. The intermediary is the party that has made the supply that may have been subject to inadvertent exemption. Often the recipient has far greater internal tax resources including possibly a sales tax specialist, and after all the recipient will be asked for the tax when the intermediary is assessed, so F.I. buyers can eliminate the bad will and cost of mistakes from their intermediary structures by embracing a good European habit. That involves conducting reviews of all costs incurred to get product to market, and ensuring that the true, if appropriate, GST inclusive, cost is known. At 6%, this may not be disastrous, but at 17.5% in the U.K, it can make the difference between viability or not on sales conduits or business lines.

One other area of oversight is when additional agreements are put in place for additional lines or areas where additional responsibilities are added for additional consideration. Both parties already have an established intermediary relationship covering a wide range of responsibility and "direct involvement" of the kind required by the Policy Statement. The nature of the service is an exempt intermediary service, but the additional agreement can sometimes only comment on the additional roles, which, considered in isolation based only on what is in the agreement, will likely be viewed as taxable. Consequently the comprehensive role should always be documented, when trust and familiarity between the parties may not otherwise require it.

P-239 has a number of worked examples which are useful as far as they go, which is not too far beyond the obvious and traditional intermediary roles. Example number 6 concerns a supplier of merger and acquisition services, and comments of the uncertainty at the outset of the relationship what the ultimate transaction will be- an exempt share sale or an asset sale. The facts are very convenient in that payments are on deposit, and the M&A service provider is not placed in the position at point of filing the GST return of having to be clairvoyant, because the GST treatment of the fees is aligned with the ultimate transaction, which might be a year and a half, or eighteen GST returns down the road. Real life M&A service providers may not always have such convenient facts, and so will have some difficulty. Clearly there is scope here for an industry wide agreement with the CRA on a practical way to provide certainty for filers, and perhaps with a sliding or annual recalculation method for ITC's some comfort for the CRA that appropriate GST recovery resulted, even if on a rolling three year basis.

We will not often see the CRA pressing for the broadness or inclusiveness of the exemption. Although the decision in the *Royal Bank of Canada* [2002-2478(GST)] group case has been appealed, it was interesting to see the CRA preferring an exempt view of a distribution service over the taxable treatment adopted by Royal Bank and one of its subsidiaries. Watch the Appeal closely, it will be of some interest on the subject of “arranging for” but probably of greater interest for the light that may be cast upon a little used structure in Canada, that of dual or concurrent employment.

The case of *La Banque Canadienne Imperial de Commerce* [2004-1427(GST)G] should be noted, if only to ensure readers are encouraged to completely disregard it as relevant reading to assist in an understanding of “arranging for”. Simply as a comprehension exercise, examine the service considered and hold it up against the criteria in P-239. You will likely conclude that it qualifies on all counts, and yet the Tax Court found otherwise, most significantly because it limited its view on the existence of a “financial service” to the original issue of the loan. Clearly, financial services flow each time payments of interest and principal occur, but without that essential plank in place, the misapprehension tumbles into a very unlucky result for the CIBC. Unfortunately, retroactive legislation has now precluded an appeal.

3. Recipient

A significant difference between the Canadian GST and the Value Added Tax in place in the E.U. is that the GST is a tax on the consumer, rather than a tax on the supplier. This significant deviation results from the key objective that the GST ultimately evolve, through provincial harmonization, into Canada's national sales tax, replacing provincial sales taxes brings with it a constitutional restriction, that provinces are unable to impose taxes on the vendor. Any advisor dealing with clients based in Europe, or liaising with European advisors will have had experienced European bemusement with this key distinction. Whereas in Europe, consideration is necessary to constitute a supply for VAT purposes, and many disputes have hinged on whether consideration was present, the Canadian definition of supply is extremely broad, and so we instead are now increasingly seeing cases where the identity of the "recipient is key to the tax result. Given that the tax is imposed on the consumer, it is then necessary, unlike in Europe, to be absolutely clear on who is the consumer or the 'recipient' of the supply. The made in Canada solution to this is a very simple, literal definition –

Ss 123(1) "recipient" of a supply of property or a service means

- (a) where consideration for the supply is payable under an agreement for the supply, the person who is liable under the agreement to pay that consideration,*
 - (b) where paragraph (a) does not apply and consideration is payable for the supply, the person who is liable to pay that consideration, and*
 - c) where no consideration is payable for the supply,*
 - (i) in the case of a supply of property by way of sale, the person to whom the property is delivered or made available,*
 - (ii) in the case of a supply of property otherwise than by way of sale, the person to whom possession or use of the property is given or made available, and*
 - (iii) in the case of a supply of a service, the person to whom the service is rendered,*
- and any reference to a person to whom a supply is made shall read as a reference to the recipient of the supply.*

To whom a supply is made can change the GST status of that supply in a number of areas including imports and exports. For supplies of financial services, however, the definition of recipient is relevant because some supplies may be taxable or exempt depending on whom they are made, and as we will see, GST recovery may or may not be possible depending on whether the recipient is an entity engaged in commercial activities. Determining 'recipient' status has been pivotal in a number of significant GST disputes which are at various stages. The pivotal function of the definition can be illustrated by examining only a very small number of examples. Even the selection commented on is sufficient to demonstrate that extreme care is needed in structuring arrangements in order that 'recipient' status is not conferred on the wrong entity, or an entity that cannot recover GST. In addition, there is an increasing trend or temptation to broaden the literal definition of recipient to include other more European concepts such as who uses consumes or enjoys the good or service, or to consider who is the "beneficiary" in an attempt to get to the right result.

- i) Deferred sales commissions in the Mutual Fund sector; – join the (q) queue.

One of a number of areas of dispute currently troubling the Mutual Fund sector is the inadvertent conferral of the recipient status upon a Mutual Fund, as opposed to the investor this has given rise to very large proposed assessments and significant concerns, the impact of which would rest with Fund Managers. Fund Managers typically supply a variety of services to the Mutual Fund, all of which are subject to GST under the (now) all encompassing exclusion from the definition of financial service provided in subparagraph (q).

(q) The provision, to an investment plan (as defined in subsection 149(5) or any corporation, partnership or trust whose principal activity is the investing of funds, of

- (i) a management or administrative service, or***
- (ii) any other service (other than a prescribed service),***

if the supplier is a person who provides management or administrative service to the investment plan, corporation, partnership or trust.

The catch-all nature of (q) means that any service flowing to the Fund from the Manager will be subject to GST, regardless of nature (unless one of the limited number of prescribed exceptions applies). The consideration at the heart of the current tension is a payment for intermediation services levied upon the investor. In simple terms, an investor is often given the choice when investing in a Mutual Fund. The investor can pay a commission upfront, or can elect not to pay that commission upon purchase, and then will only be subject to a sales commission if they disinvest within a specified number of years. The deferred sales commission declines to zero over a period of years, but should the investor disinvest while the deferred sales commission is payable, then the amount is deducted by the Fund Manager before distributing the proceeds of the redemption of Mutual Funds to the investor. So, the deferred sales commission is simply an amount payable by the investor for exempt intermediation services – it is the ‘pay later’ option from the choice of ‘pay now or pay later’.

The intermediation service is exempt by nature, and the investor is the recipient.

How has it come about that the CRA assert that the GST applied to deferred sales commissions received by Fund Managers? In order to satisfy the varying requirements of lenders, some Fund Managers modified a variety of documents such that the receivable deferred sales commissions were arguably payable either by the Mutual Fund, or jointly by the Mutual Fund and the investor. Now, if on the basis of the documentation, *the Fund* rather than the investor is the person liable to pay these deferred sales commission, then the CRA is quite correct in asserting that subparagraph (q) will apply tax to the deferred sales commission when it is received by the Manager. This, notwithstanding that the Fund could not be said to have received any supply of intermediation, or to have used consumed or enjoyed any of the services for which the deferred sales commission is consideration or a number of other regulatory and industry prohibitions on precisely what fees or charges Fund Managers can levy upon Funds.

The CRA has issued a number of sizeable proposed assessments and assessments, demanding that the affected fund managers pay GST on deferred sales commissions received within the last 4 years. The proposed assessments constitute a massive penalty for a documentary misstep which was the result of commercial lending requirements, and not any other tax planning reason. Clearly, the service of intermediation for which the deferred sales commission is consideration is intended to be exempt, and so the proposed assessments coming from the CRA run against the grain of the policy intent in this area, and cannot be said to be part of the CRA discharging its obligations to protect the tax base – this is merely an accidental inclusion in the base.

How is this dispute progressing? One fund manager, CI Mutual Funds successfully obtained a rectification order from the Ontario Court to the effect that, notwithstanding the documentary missteps, the deferred sales commission is not, payable by the Fund. This would appear to successfully detach the ‘recipient’ definition from the Fund(s), and would appear to resolve the dispute in the case of this particular Fund Manager. Unfortunately, documentary modifications are likely to be different in every case and so other Fund Managers facing these proposed assessments may or not be able to resolve the matter in the same fashion as C.I. When any documentation is modified, therefore, when any structures are put into place, a sensible part of the assembly procedure should be a review of the structure through the prism of ‘recipient’, to see whether any inadvertent or unfortunate GST results occur.

The definition of “recipient” has been slightly stretched through cases involving services related to real estate, *Bokrika Inc.* [2000-3495(GST)G], and *Immeubles Sansfacon Inc.* [99-203(GST)]. Both are interesting in that they bring into the evaluation of who is recipient, a slightly broader view on where the costs reside. Even though there may not be a literal obligation for the person viewed by the Court as recipient to pay for the supply, and even though the person that undertook to pay for the supply was not a true agent of the “recipient”, clearly there is some degree of flexibility here beyond a strict application of the definition.

These cases are not evaluated in detail, because an upcoming case is likely to incorporate and summarise all we have seen to date on the matter of “recipient”. That case, *General Motors of Canada Limited*, involves costs incurred by the employer for services that may be said to have been enjoyed primarily by the Pension Plan. On the subject of who i.e. employer or pension plan, is the recipient, we can expect to see full arguments from both sides. This case considers a matter of GST recovery by the employer that is common to many taxpayers. In other words significant amounts of revenue are at stake. The matter is at the confluence of many uncertainties referred to in the title of this paper, involving the treatment of investment management services, the status of recipient, the effectiveness of Section 155, and whether the CRA’s view of matters as set out in TIB 032-R meets with the Courts view.

4. Imported Services – a new state of affairs

The *State Farm Mutual Auto Insurance Company* decision issued on January 30th 2003, raised a number of questions about the effectiveness of Division IV in successfully constructing a deemed supply between establishments straddling the Canadian border. In addition it highlighted the view held by many, that the dominant nature of services that flowed between branches of financial institutions were in fact exempt financial services. In November 2005 Finance issued News Release 2005-079-Legislative Proposals Draft Regulations and Explanatory Notes relating to the Excise Tax Act. A part of this release was detailed proposals on The GST/HST Treatment of Imported Supplies. When the outline for this presentation was submitted, it was anticipated that by October 2006, taxpayers would have at least draft legislation to consider for estimating their 2006 liabilities. Annual GST Returns are due at the end of January 2007, although payments of tax collectible under the new Proposals are predicted in the document to be remittable no earlier than June 2007. To date however, all we have seen is the Finance Release. Described in the Release are a completely new structure and a whole collection of new concepts that will apply to replace the legislation considered by the Tax Court in the State Farm Case. These structures have already been commented on in a number of tax publications, and also during the Spring 2006 CICA GST Updates held in Toronto and Calgary, and the relevant slides from those presentations will be appended to the slides accompanying this document on the CICA website

Should we not see any more on the subject from Finance in time for the June 2007 deadline, then these slides (developed in conjunction with Mr. Danny Cisterna of Deloitte), will be a useful aid for those taxpayers that are inclined to pay monies in June 2007, as or on account of tax, on the basis of a Department of Finance Press Release, which really constitutes no more than a detailed and convoluted advice of intent. To pay monies over as or on account of tax in this way may render them unrecoverable two years after payment, however, should the proposals not take legislative form in a fashion exactly as predicted in the Press Release, or indeed at all. Consequently, depending on where matters have progressed to by June 2007, taxpayers may wish to explore alternative ways to place sufficient monies on deposit with the CRA to insulate against penalty and interest should law ultimately take effect to require payment, while preserving the right to a refund of those monies should matters deviate from the intentions set out in the Press Release.

The situation in which affected taxpayers find themselves at the time of this presentation is not one complimentary to the machinery of Canadian government. The dispute between State Farm and the CRA on the application of Division IV had its origins in the early 90s (State Farm did not self assess tax from the outset), made its way into the Tax Court in October 2002, and received a decision in January 2003. The Tax Courts decision in that case was not appealed. Twenty two months later, Finance released a plain language description, predicting a legislative response which in some respects is to be retroactive to the inception of the GST. Almost one year later in October 2006, taxpayers contemplating the filing of the 2006 calendar returns still do not have legislation on which to base any filings due in January 2007.

The new concepts are not simple and include “qualifying taxpayer”, “qualifying exclusion”, “resource use condition”, “resource allocation condition”, “designated business”, “support resource”, “labour resource situated outside of Canada”, “intangible resource” . There is also a category of expenses to be valued, referred to as “loading” defined....

“Loading” includes any part of the consideration for a non-arms length financial service supply that is included in the consideration for the supply to cover administrative expenses, an error or profit margin, business handling costs, commissions (other than commissions for a commissioned financial service, described above), communications expenses, claims handling costs, employee compensation or benefits, execution or clearing costs, management fees, marketing or advertising costs, occupancy or equipment expenses, operating expenses, processing costs and other costs or expenses of the related FI that made the supply. If the financial instrument supplied is an insurance policy, loading will also include any part of the consideration for the supply that is included in that consideration for the purposes of covering policy acquisition costs and premium collection costs.”

When the mechanism for taxing services imported into Canada was originally discussed, one concept, usually considered by any jurisdiction introducing a value added tax was aired. That concept was that subject to being able to evidence how much of the ‘imported supply’ originated as salary costs within the supplier. That amount could be excluded from the self-assessment requirement, in an effort to avoid discriminating against entities which straddle the border compared to those existing entirely within it. This mitigation mechanism was not implemented in Canada for the same reason as other jurisdictions, namely, that the establishment or entity receiving the supply will have difficulty in relying on information required of the supplier which is outside Canada. The valuation of the salary element may be open to abuse, and ultimately may prove to be unauditible. If determination of the salary content of a composite supply was considered to be potentially unauditible, how difficult and time consuming will it be for the tax payers and the CRA to attribute values and reach a satisfactory audit conclusion on all of the various items contained in “loading”? Anyone who has considered the high degree of variance between entities in practices to capture and categorize costs will appreciate the magnitude of this challenge. For example, some entities take all information technology costs and ‘bake’ them into headings such as “claim handling, commission (or for insurers, acquisition cost) and communications, whereas other organizations are content to leave information technology as a free standing cost.

If these proposals are to move forward then taxpayers will need draft legislation very soon.

There are very good reasons why Canada should *not* move forward with the proposals in the November 2005 Announcement, and should instead pursue other options.

Canada is an active participant in OECD working groups on VAT, and a number of participants have pointed to the real possibility of a VAT Chapter in Tax Treaties, or Multi- party Treaties dealing with international VAT treatment of international supply flows. These latest Proposals in Canada are taking us in diametrically the opposite direction to the EU; they are extremely cumbersome and convoluted to contemplate even for an isolated computation in Canada. They are

a completely unsuitable structure if, as seems likely, we may subsequently want to “dovetail” with other jurisdictions to ensure Canadian commerce benefits from any reciprocity clauses.

A key factor in the review of the VAT impact on the financial sector in the EU was a recognition of the damping effect VAT costs were having on cross border transactions, and that thread of concern has led to consideration of a variety of specific VAT reliefs, not just on intra-group supplies but also possibly on cross-border supplies between third parties in some circumstances. In the European Financial sector, the very real concern is that Banks and Insurers would be unable to compete with what are referred to as ‘super league’ players based in the U.S. Canadian Banks have for some years been pleading the imperatives of facilitating scale and outsourcing as survival issues. The Canadian GST model currently hampers both, and these latest labyrinthine proposals will only exacerbate matters. The ‘super-league’ leviathan entities that have the EU Internal Market Commissioner so concerned for the welfare of European F.I.’s are so close to us that we have shared power outages with them. Maybe we should perform a U-turn in our GST policy and head in the same direction as Europe?