Unexpected Tax Leakage Caused by Election for GST/HST Exempt Supplies: Financial Institutions Beware!

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- In a decision handed down on May 29, 2018, the Tax Court of Canada dismissed an appeal by a subsidiary ("the Subsidiary") of a leading Canadian bank ("the Bank") to claim input tax credits ("ITCs") for expenses attributable to certain exported supplies made by it to the Bank's branches located outside Canada.
- Among its other activities, the Subsidiary (an investment bank) provides administrative services to the Bank in connection with the Bank's activities outside Canada. In reporting periods from 2008 to 2013, the Subsidiary claimed ITCs with respect to expenses allocable to those services.
- As members of a "closely related group", the Bank and the Subsidiary had made an election under subsection 150(1) of the *Excise Tax Act* ("ETA") (a "150 Election") as a result of which supplies made between the two entities were deemed "financial services" and were thus exempt under section 2 of Part VII of Schedule V (the "Exempt Schedule"). Registrants that make exempt supplies **cannot** claim ITCs on inputs related to such supplies.
- However, Part IX of Schedule VI of the ETA (the "Zero-Rated Schedule") establishes the general principle that exported supplies are zero-rated (i.e., taxed at 0%). Registrants **may** claim ITCs on inputs related to zero-rated supplies.
- As the Court stated, "**the overarching issue is whether these exported supplies are zero-rated supplies or exempt supplies**; if zero-rated, ITCs may be claimed by the Subsidiary, if exempt supplies, they may not."
- For the reasons discussed below, the Court accepted the Minister's position that the ITCs had been correctly disallowed and dismissed the Subsidiary's appeal.

Positions of the Parties

The parties submitted a statement of agreed facts, as their dispute was only over how to resolve the apparent conflict between the Zero-Rated and the Exempt Schedules. The Minister's position, which was based on the fact that the two entities had entered into a 150 Election, may be summarized as follows:

- Section 2 of Part VII of the Exempt Schedule provides specifically that **any** supply deemed under a 150 Election to be a financial service is exempt under such Schedule.
- Because registrants making exempt supplies **may not** claim ITCs on inputs related to such supplies, the Subsidiary could not claim ITCs with respect to its supplies to the Bank's foreign branches.

In appealing against the Minister's reassessment, the Subsidiary made two distinct arguments. The first was that the 150 Election did not apply to the supplies because (on the basis of subsection 132(3) of the ETA) the Bank was deemed to be a "separate person" in respect of its activities outside Canada that were carried out through its non-resident branches. The Subsidiary argued that such "separate person" was not a party to the 150 Election between it and the Bank.

The Subsidiary's alternative argument was that, even if the 150 Election were found to apply to the exported services, those deemed financial services would still be **zero-rated** under Part IX of the Zero-Rated Schedule as a supply of a financial service made by a financial institution to a non-resident person. As such, ITCs **could** be claimed.

The Issues

As stated by the Court, the issues were therefore as follows:

1. Does the 150 Election apply to supplies made to a non-resident branch and deem such supplies financial services?
2. If the answer to (1) is yes, and the 150 Election does apply, are the exported financial services exempt supplies under the Exempt Schedule or, alternatively, are they zero-rated under the Zero-Rated Schedule?

The Ruling

Justice Bocock discussed the apparent conflict between sections 132 and 150 of the ETA, in relation to whether ITCs may be claimed on exported services. In reasoning through the conflict, he employed a three-part analysis, made up of textual, contextual and purposive components of the relevant provisions of the ETA.

Issue #1: The "deemed separate person" argument

Justice Bocock examined the Subsidiary's "deemed separate person" argument, relating to the context and purpose of section 150 and subsection 132(3). With respect to the former, he noted that section 150 provides commensurate tax treatment between every supply received by a person made by a closely related entity. While ITCs cannot be claimed on services provided to closely related entities, a supplier to a closely related entity need not charge and collect GST/HST.

While subsection 132(3) decouples the non-resident branch's activities from the activities of the related group in Canada, it does **not** state that the non-resident branch, for the purposes of supplying goods and services, is a deemed separate person. Justice Bocock noted that his conclusion with respect to subsection 132(3) is supported by the wording of the following subsection 132(4), which clearly deems permanent establishments "separate persons" for the purposes of providing supplies. If Parliament's intention for subsection 132(3) had been to deem closely related entities separate legal persons, then it stood to reason that it would have said so, just as it had in subsection 132(4).

For these reasons, the Subsidiary's "deemed separate person" argument was rejected.

Issue #2: Resolving the conflict between the Schedules

The consequence of Justice Bocock's interpretation of section 150 and subsection 132(3) is that a conflict of purpose exists. Supplies exchanged between the Subsidiary and the Bank are deemed, by virtue of the 150 Election, to be financial services. Financial services, as mentioned above, are considered exempt supplies as per section 2 of Part VII of the Exempt Schedule. However, since the services that the

Subsidiary supplied to the Bank were exported and not consumed in Canada, they are **also** properly characterized as zero-rated supplies. The problem, therefore, was to find a way to reconcile the substantive effect of the 150 Election, which imposes GST/HST on financial services, with the overarching principle that exported supplies are not subject to GST/HST.

Textual analysis

Justice Bocock began by addressing the textual component. Section 150 of the ETA expressly states that, upon filing the prescribed election, every supply between the parties that would be a taxable supply is deemed to be a supply of a financial service. Both Part VII of the Exempt Schedule and Part V of the Zero-Rated Schedule refer to "financial services", producing the conflicting approaches that were referred to above.

Justice Bocock ultimately found that subsection 150(1) of the ETA is clearly referenced in the Exempt Schedule and that, in addition, the Notes related to that reference indicate a preference for the Exempt Schedule's application "where a subsection 150(1) election has been made by closely related corporations". Therefore the textual analysis favoured the Minister's position.

However, while Justice Bocock acknowledged that the textual component is a good starting point, and that it suggested that the Exempt Schedule prevailed over the Zero-Rated Schedule on this point, he was of the view that a purposive or contextual analysis could potentially tip the balance in the other direction.

Purposive analysis

Proceeding to the next stage of his consideration, Justice Bocock borrowed from the purposive analysis in *National Bank Life Insurance v. Canada*, 2006 FCA 161. Applying the reasoning in that case, he asked whether section 2 of Part VII of the Exempt Schedule overrides section 1 of the same Schedule, which states that a supply of a financial service that is not included in Part IX of the Zero-Rated Schedule is exempt. His finding: it does. Prior to the enactment of section 2, deemed financial services under a 150 Election would fall either into the Exempt Schedule, if they were consumed domestically, or the Zero-Rated Schedule, if they were exported. However, with the enactment of section 2 – which explicitly mentions deemed financial services captured by 150 Elections **without** making any differentiation between domestically consumed and exported services – such supplies are exclusively redirected to the Exempt Schedule as exempt supplies.

It was for this reason that, at para. 55, the Court concluded: **"a taxable supply originating in Canada and also deemed a financial service by virtue of the s. 150 election is an exempt supply even where exported to a non-resident branch"**.

Key Takeaways

- The Court determined that a taxable supply originating in Canada and also deemed to be a financial service by virtue of a 150 Election is an exempt supply, even where exported to a non-resident branch. (see para. 55)
- This conclusion runs contrary to the overarching principle that tax ought only to be imposed on supplies made and consumed in Canada (i.e. because exported deemed financial services, once a 150 Election applies, become subject to GST/HST).
- Two of the ripple effects of Justice Bocock's decision are (i) that Canada's domestic consumption taxes render exported deemed financial services less competitive, and (ii) that the federal treasury in turn receives a windfall of GST/HST on exported services never consumed in Canada. (see para. 56)

- The Court shows a preference for specific contextual interpretation of the ETA, as was clearly delivered in *National Bank Life*, though its sympathy for general purposive consistency remains a strong force.
- Businesses with a 150 Election in place (or considering putting one in place) should carefully examine the potential consequences of this decision if their operations involve entities with non-Canadian branches.
- As a lower court is normally bound by *stare decisis*, Justice Bocock had no option but to follow the Federal Court of Appeal reasoning in *National Bank Life* "on specific contextual interpretation within the ETA" (see para. 56). However, the Federal Court of Appeal will have the opportunity to revisit this "contextual versus purposive conflict" as the Subsidiary filed an appeal on June 21, 2018.