RECENT GST/PST ISSUES

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PROFESSIONAL PROFILE

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MILLAR KREKLEWETZ LLP

is a boutique tax law firm specializing in
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Commodity Tax – Rob's Commodity Tax practice encompasses all Canadian indirect taxes, and includes all matters relating to Canada's Goods and Services Tax (GST) and Harmonized Sales Tax (HST), and all matters relating to Canada's various provincial sales taxes – like the Ontario, Manitoba and Saskatchewan retail sales taxes (RST), the British Columbia social services tax (SST), and the Quebec sales tax (QST). His Commodity Tax practice also encompasses a variety of other indirect taxes, like the Employer Health Tax (EHT), and a range of excise taxes applying to goods like tobacco, alcohol, jewellery, gasoline and other motive fuels.

Customs & Trade – Rob's Customs & Trade practice encompasses all matters involving customs and trade. On the Customs side, this includes Tariff Classification, Origin, Valuation, Marking, Seizures, Ascertained Forfeitures, and Administrative Monetary Penalty (AMPs) related matters. On the Trade side, this includes North American Free Trade Agreement (NAFTA) matters – including NAFTA Origin, Exporter Verification, and Government Procurement issues – as well as Anti-dumping / Countervail (SIMA), World Trade Organization (WTO) and GATT matters.

Related Matters – Finally, Rob also specializes in a number of other tax and trade related areas, including the tax, customs and competition issues arising on the establishment of a business in Canada; the valuation and transfer pricing issues arising between multinational enterprises; the issues arising on the transfer of business personnel to Canada; disputes relating to employee vs. independent contractor status under Canada's various federal and provincial tax legislation; and on all other matters relating to the cross-border movement of goods, services and labour.

Extensive Litigation Experience

Tax & Trade Litigation is an integral element of Rob's practice, with Rob litigating tax and trade matters before all relevant bodies, tribunals and courts, including the Tax Court of Canada, Canadian International Trade Tribunal, Federal Court, Federal Court of Appeal, and Canada's various provincial Superior Courts and Courts of Appeal, and the Supreme Court of Canada. At Millar Kreklewetz LLP, we believe our "hands-on" tax and trade knowledge, combined with our litigation skill, gives us a competitive advantage.

Rob's practice also includes representation work before all government levels.

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- software & IT
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- drugs & pharmaceuticals
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- manufacturing
- wholesaling
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Speaking Engagements

Publications

Memberships

Rob has published over **300 articles and papers**, and spoken at over **100 conferences**.

Accordingly, Rob regularly addresses the Tax Executive Institute (TEI) – at its Annual Canadian and International Conferences, and at various provincial Chapter Meetings – and also speaks frequently before other organizations on like the Canadian Tax Foundation (CTF), Canadian & Ontario Bar Associations (CBA/OBA), Canadian Institute of Chartered Accountants (CICA), and Certified General Accountants (CGA).

Rob also regularly addresses industry-specific associations like the Canadian Association of Importers & Exporters (CAIE), American Petroleum Institute (API), and the American Toy Industry Association (TIA), the Canadian Finance and Leasing Association (CFLA), and the Canadian and U.S. Direct Sellers Associations (DSA), while speaking also speaking annually at other Professional Conferences held by organizations like the Strategy Institute, Infonex, IIR and Federated Press.

Rob is also a regular contributor on commodity tax and customs & trade in the Tax Foundation's *Tax Highlights* publication, and a number of other publications, including Carswell's *GST and Commodity Tax Reporter,* the Ontario Bar Associations *Tax Newsletter,* Federated Press's *Sales and Commodity Tax Journal*, and the CAIE's *Tradeweek* publication.

Rob is a member of the OBA's Tax Executive and International Law Executive, a member of the CFLA's Tax Committee, and Chair of the DSA's Taxation Committee. Rob is also a member of several federal and provincial consultation groups, consulting both with the federal Department of Finance, and the Ontario Ministry of Finance.

The Real Important Stuff

Unfortunately Left to the Bottom

Rob is married to **Franceen**, has a beautiful 6 1/2 year-old boy named **William** (the "Conqueror"), who has a one year-old brother named **Richard** (the "Lion-Hearted").

While Rob concedes that Commodity Tax, Customs & Trade is truly scintillating, what he really enjoys is spending time with his family, playing golf with William, and attempting to finish at least one woodworking project he starts.

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(International Law Review, April 2004)

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INTRODUCTION

Commodity taxes remain an important part of tax advice to any client, and also requires constant vigilance in continuing education.

Part I of the Paper will provide a detailed look at three important commodity tax changes in the last year. While the focus on each of these changes will be comprehensive, the three changes discussed are not meant to be a comprehensive survey of what has changed in commodity taxes over the last 12 months. The topics are meant, however, to provide a detailed background for the discussion on commodity taxes that has been allotted in this year's programme.

Part II of the Paper will provide an introduction to GST and RST for the tax professional, and is aimed at providing a building block discussion for any reader feeling the desire for one. Part II will also ensure that every reader is given the background necessary to fully understand the concepts discussed in Part I.

PART I

WHAT'S NEW IN COMMODITY TAXES

(A REVIEW OF SELECTED ISSUES)

I - 1 ONTARIO'S NEW RELATED PARTY RULES [1]

Ontario has finally released much-anticipated (and long awaited) proposed amendments relating to the application of its retail sales tax ("RST") to related party corporate (and partnership) transactions.

While promised as early as the 1998 Ontario Budget, and "re-promised" in the 2004 Budget, Ontario only published draft rules on July 20, 2004 for the modernization of its related party rules in section 13 of Regulation 1013 under the Ontario *Retail Sales Tax Act* (the "RSTA").[2]

Among other significant changes, these proposed rules, for the first time, aim to legislate the application of RST to certain partnership transactions.

Before reviewing the proposed rules, it is worth first considering what the situation was under the old rules,[3] which will help the reader to better comprehend the improvements that have been made to the old rules, and the potential pitfalls that remain.

I - 1.1 Review of the Former Rules

Ontario's related party rules are found in section 13 of Regulation 1013.

While the Ontario RST has been in place since 1961 and the rules in Regulation 1013(13) have been in place almost as long, they have since past their "best before date" in terms of efficient application to modern corporate transactions. Given the nature of concerns that have been historically raised in connection with the old rules, some degree of modernization was in order.

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[1] The author acknowledges the assistance of Karen L. Willans in the preparation of this section. Karen is an associate with Millar Kreklewetz LLP, and practices within the Commodity Tax, Customs & Trade areas.

[2] R.S.O. 1990, c. R. 31, as amended.

[3] We refer to the current rules in Regulation 1013(13), throughout, as the "old rules". Please note, however, that these rules will remain in effect until the new rules are promulgated. When brought into effect, the "new rules" are intended to be effective July 20, 2004; hence our relegation of the current regime in Regulation 1013(13) to "old rule" status.

I - 1.1(a) *No Fit with Common Income Tax Transactions*

The rules in Regulation 1013(13) have never – to the chagrin of many an income tax practitioner – fit "hand-in-glove" with many common income tax provisions (*e.g.,* section 85 roll-overs and butterfly transactions).

However, as these rules were in place well prior to the 1972 restructuring of the *Income Tax Act* (Canada), this should not be a surprising observation.

I - 1.1(b) *Difficult & Limited Application*

Perhaps a greater criticism of the old rules has been the practical difficulty one has in attempting to apply them, as they are both in fact and practice quite limited in their potential application.

First, the application of the old rules is currently predicated on two basic pre-conditions being precisely met: (a) the use of the rollover provision must be a "first time", at least from the perspective of the tangible personal property ("TPP") that is being sought to be transferred on a non-taxable basis;[4] and (b) the person wishing to benefit from the non-taxable treatment must be able to demonstrate that all RST ever imposed on any purchaser of the subject TPP has been paid at all times in the past.

These pre-conditions were historically quite daunting, and they usually left some uncertainty in the minds of advisors or taxpayers relying on them. As a practical result, there were (and currently are) very few situations where these rules could be seen to clearly apply.

Finally, and even when the difficult pre-conditions could be seen to be met, Ontario was known to take a fairly narrow view of the application of the Regulation 1013(13) rules – requiring the entire section to be read with care each time resort to the rules was needed.

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[4] In other words, once Regulation 1013(13) has been used, it cannot be used in respect of the same TPP again.

I - 1.1(c) *Historical Traps*

The old rules were also fraught with potential traps for the unwary. For example, the degree of "relatedness" required was actually quite high, with Ontario requiring 95% beneficial ownership between the parties, in which case the companies were said to be "wholly-owned". Another example involves the limited nature of the "indirect" relatedness that Ontario allowed.

That is, where two companies were "wholly-owned", Ontario allowed tax-free asset transfers from one to the other, if the pre-conditions were met. However, if they were wholly-owned in an indirect manner, it was often uncertain whether the related party rules could be relied upon. (Figure 1 provides some examples of the historic difficulties.)

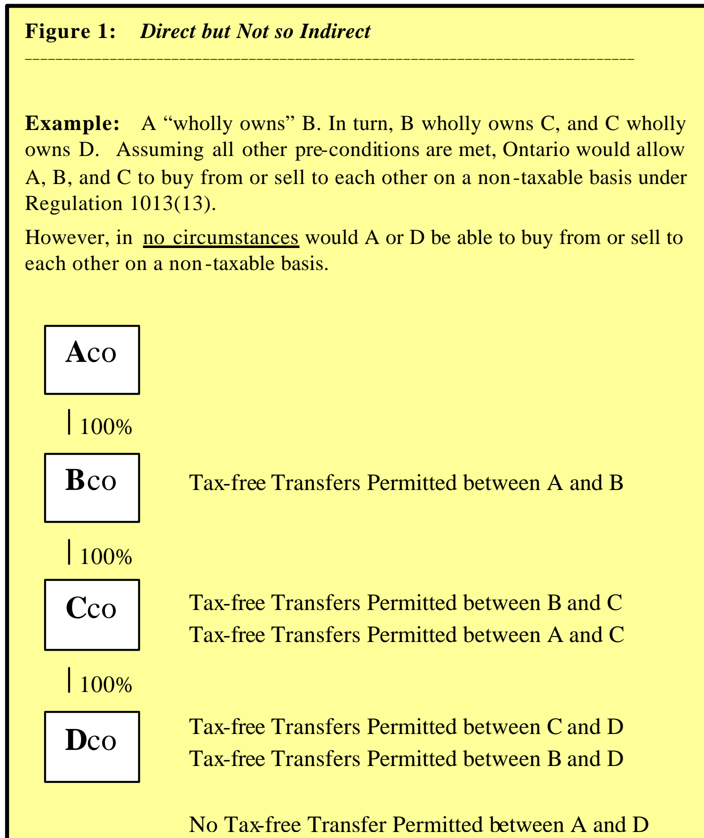


Figure 1: ***Direct but Not so Indirect***

I - 1.2 Proposed New Rules

I - 1.2(a) *Elimination of the One-Time-Use Requirement*

Perhaps the most significant change in the rules has been the elimination of the "Pre-Condition" approach, and the adoption of an "eligible property" definition - which had, respectively, the effect of doing away with the "one-time-use only" position, and allowing a now limitless ability to transfer eligible property on a tax free basis (provided all other conditions are met).

While the definition of "eligible property" is complex, it effectively requires that the TPP that is to be transferred on a tax-free basis to have been tax-paid. (See Figure 2 for the definition of "eligible property".)

I - 1.2(b) *Assets Must be "Tax Paid" – Not Last Acquired Exempt, or for "Resale"*

Another special rule, in subsection 13(6), confirms Ontario's prior administrative position that, in instances where the subject property was either (1) acquired on an exempt basis (e.g., custom computer software), or (2) acquired on a non-taxable basis (e.g., "for resale"), the related party exemptions will not apply (at least until RST is paid at least once).

In terms of impact, this rule will most significantly affect the transfer of custom computer software amongst related corporations, with the proposed regulations ensuring that at least the first such transfer is *taxable* – unless otherwise exempt as part of the special rules on software.[5]

In other situations, however, the rule will not be as draconian as it seems. For example, if the goods were unconditionally exempt when acquired originally (e.g., foodstuffs; raw materials for manufacturing), they may also qualify for unconditional exemption on the subsequent related party sale – perhaps obviating the need for reliance on the related party rules entirely. The same result would arise if the TPP being sold were being acquired by the related party "for resale" purposes.

Figure 2: ***Definition of Eligible Property***

5. Subject to subsection (6), tangible personal property is eligible property if one of the following conditions is satisfied:

1. Where the transferor of the property is an individual, it is eligible property if tax was paid under the Act,
   - i. by the individual,
   - ii. by a corporation that the individual wholly owns at the time of the transfer, or
   - iii. by a corporation that is related to a corporation that the individual wholly owns at the time of the transfer,

   in respect of the purchase, use or consumption of the property.
2. Where the transferor of the property is a corporation, it is eligible property if tax was paid under the Act,
   - i. by the corporation,
   - ii. by an individual who wholly owns the corporation at the time of the transfer, or
   - iii. by a corporation that is related to the transferor at the time of the transfer,

   in respect of the purchase, use or consumption of the property.
3. Where the transferor of the property is a partnership, it is eligible property if tax was paid under the Act,
   - i. by the partnership,
   - ii. by an individual or corporation that contributed the property to the partnership and was a member of the partnership after the tax was paid, or
   - iii. by a corporation that, at the time of the transfer, is related to a corporation that contributed the property to the partnership and was a member of the partnership after the tax was paid,

   in respect of the purchase, use or consumption of the property.

6 For the purposes of subsection (5), tax is not considered to have been paid under the Act in respect of the purchase, use or consumption of tangible personal property,

a. if no tax was payable under the Act in respect of the purchase, use or consumption of the property; or
b. if no tax was payable under the Act in respect of the purchase of the property because it was purchased for the purposes of resale.

---

[5] An exemption could apply if the custom software is transferred as part of a business, and the other requirements in Regulation 1012(14.2)(2)(f) are met.

I - 1.2(c) *Move to Eligible Property Progressive*

Accordingly, and for the most part, the move to the "eligible property" definition will probably be quite welcomed by taxpayers wishing to rely on the new related party rules, since under the old rules, and in the context of modern-day corporate restructuring, the "one-time-use" rule generally rendered Ontario's related party transaction rules "irrelevant".

The challenge that taxpayers historically had in tracking and evidencing payment of RST for the assets being transferred under Regulation 1013 remains however, and this raises a renewed need for proper record keeping, as it relates to the RST paid on large-ticket (or long life) assets.

I - 1.2(d) *The Threshold for "Wholly-Owned" Corporations*

The proposed rules will retain the 95% threshold for closely related corporations, ensuring that, in order for one corporation to "wholly-own" another, it must hold a 95% beneficial ownership interest in it.

Accordingly, "wholly-owns" or "wholly-owned" will continue to mean, in respect of a corporation, the beneficial ownership of not less than 95% of the total issued and outstanding share capital of a corporation (exclusive of directors' qualifying shares).[6]

In another significant expansion of the relief available under the new rules, Ontario has expanded the definition of "wholly-owned" to include both "direct" *and* "indirect" ownership, dropping the limited approach set out in Figure 1 above.

The exemption in the current regulation refers to *direct* beneficial ownership or ownership through one other wholly-owned corporation.[7] Under the new rules, the proposed definition of "wholly-owns" will be expanded to include *indirect* beneficial ownership, as follows:

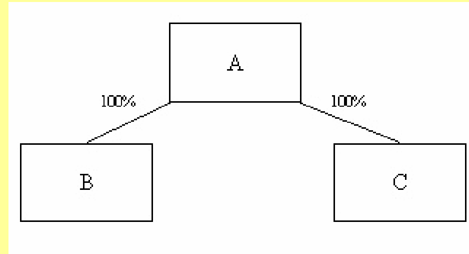
> A corporation is wholly-owned by a person or an individual, as the case may be, if the beneficial ownership of shares representing less than 95 per cent of the sum of the stated capital of all classes and series of shares of the corporation is held directly **or indirectly**,
>
> a. by the person; or
>
> b. by the individual and one or more individuals who are members of his or her family.
>
> [Emphasis added.]

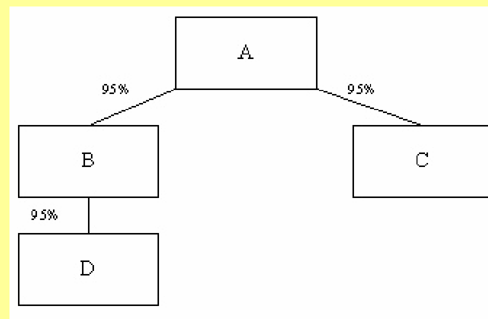
6 R.R.O. 1990, Reg. 1013, s. 1.

7 R.R.O. 1990, Reg. 1013, ss. 13(3) to (5).

Figure 3: ***Direct or Indirect Application***

Example 1: A, B and C are related corporations as B and C are wholly-owned by A. Eligible property (i.e., where tax has been paid once on the asset by either A, B or C) may be transferred between A, B and C without the payment of tax.





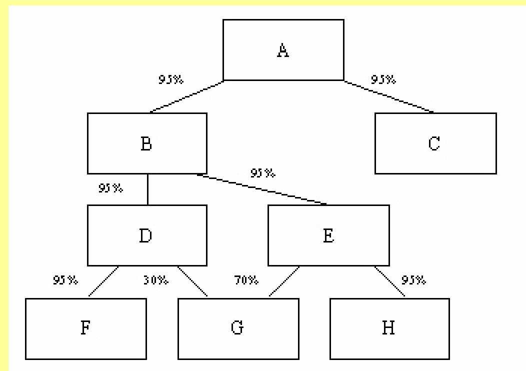
Example 2: In addition to the tax exempt transfers outlined in Example 1, eligible property could be transferred between A, B, C and D based on the corporate relationship.

Example 3: This example expands the tax exempt transfers outlined in Example 2 above.

Corporations A, B and C or B, D and E may transfer eligible property without attracting tax (same as Example 1).

Eligible property may also be transferred among A, B, C, D, E, F and H without attracting tax because of the unbroken chain of at least 95% beneficial ownership between each of the corporations (same as Example 2). Also, because of the chain of 95% beneficial ownership, G can transfer eligible property to each of these corporations without attracting tax.

However, as with Example 2, the transfers could only be exempt if they were a result of transfers between wholly-owned corporations. With the indirect nature of some of the transfers, evidence to document the beneficial



This has the effect of permitting the exemption to be used within a number of extended corporate groups, provided the 95% requisite beneficial ownership is met and provided firther that suitable evidence to document the indirect beneficial ownership is available. Figure 3 provides three examples, and is based on Ontario's July 2004 News Release (Number 04-3).

I - 1.2(e) *Holding Period*

A new rule in the proposed regulations will now require a 180-day holding period with respect to the "relatedness" of the parties. Specifically, the wholly-owned relationship between the related parties must continue for a period of at least 180 consecutive days following the date of the transfer.

The likely purpose of the 180-day rule is to ensure that the asset transfer occurs between *bona fide* related parties, and the rules are not used in tax avoidance schemes. It is also fairly clear that the 180-day requirement is the trade-off for the expansion of the rules beyond "one-time-use".

Note that special deeming provisions exist in the new rules to deem, in certain circumstances, a person to have met the 180-day holding period.

I - 1.2(f) *Pro-Rated Asset Transfers Between Unrelated Corporations*

The proposed rules also include special provisions (as was the case under the old rules) for situations in which transfers occur between related parties, but not "wholly-owned" parties.

Under the new rules, "unrelated corporations" are considered to be those corporations that are not "wholly-owned" by another person. That is, there is less than 95% beneficial ownership, direct or indirect.

Where an asset transfer occurs between unrelated corporations, the RST may be pro-rated based on the actual relatedness of the parties.[8] Specifically, the draft rules propose that no RST be payable on the portion of the value of the eligible property transferred that relates to the proportion of the share capital owned on the transfer between:

a. unrelated corporations – where the transferor directly or indirectly owns shares of the purchaser immediately after the sale;
b. unrelated corporations – where the purchaser directly or indirectly owns shares of the transferor immediately before the sale; or
c. an eligible shareholder to a corporation, or vice versa, where the eligible shareholder directly or indirectly owns shares of the corporation immediately after the sale.[9]

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8 Under the current RST regime, when an unrelated person purchases TPP from a corporation, RST is payable on the portion of the actual value of the TPP that reflects the proportion of the share capital not owned by the unrelated purchaser.

9 An "eligible shareholder" refers to an individual or partnership that directly or indirectly owns shares of the corporation, but does not wholly-own the corporation.

Similar to transfers between related corporations, the shares used to calculate the proportion must continue to be held for 180 days after the transfer. Figure 4 provides a plain vanilla example.

I - 1.3 Other Notes

I - 1.3(a) Actual Value vs. Fair Value

It is worthy of note that the current regulations use the term "actual value" and the draft regulations use the term "fair value". "Actual value" is not defined in the RSTA or in the current regulations. The RSTA does include an extensive definition of "fair value" in section 1. This change is likely just a house-keeping matter, and made for consistency purposes.

I - 1.3(b) Share Consideration

In a transaction where shares are received as consideration, the current rules provide that if the shares are received as consideration for the full value of the TPP sold, and the purchaser retains the shares for a period of not less than six months, the transfer is exempt. It follows that, if the value of the TPP is greater than the value of the shares transferred, RST will be owed on the difference.

For purposes of consistency, the draft rules state that if a person receives shares as consideration for eligible property and retains the shares for a period of not less than 180 days, no tax is payable on the portion of the fair value of the eligible property.

I - 1.4 Special Rules for Partnerships

In another new approach, rules have been added regarding the transfer of assets between partners and partnerships. These new rules are more-or-less consistent with the existing and proposed rules for asset transfers between related parties.

Figure 4: ***Transfers Between 'Unrelated' Corporations***

Example: Aco beneficially owns 45% of the shares of Bco. Aco transfers eligible property to Bco. Bco is required to pay RST on 55% of the fair value of the asset being transferred, provided Aco continues to beneficially own at least 45% of the shares of BC for a period of 180 days after the transfer

I - 1.4(a) Current Administrative Approach

Currently, no tax is payable – by way of administrative policy – on the following transfers of TPP in partnership transactions:

(1) from the partner to the partnership, on formation of the partnership, and as a contribution of TPP by the partners, provided the partner paid the applicable RST when the TPP was purchased; and

(2) from the partnership to a partner, providing the partner had contributed the TPP to the partnership and had originally paid the requisite RST.

Further, tax is currently pro-rated when TPP is contributed into a partnership by a partner on the basis of the percentage interest of the partnership held by the partner.

I - 1.4(b) *New Rules*

The draft rules add new features to the treatment of partnership assets, essentially by converting this administrative approach into an approach consistent with transfers between related corporations.

The most important new feature is the adoption of the "eligible property" definition, and the application of that definition (and its "RST-paid TPP" requirement) to partnership transactions. Under the proposed rules, no tax is payable on the portion of the value of eligible property transferred:

(1) into a partnership that relates to the percentage share of the income or loss of the partnership that the person will receive after the transfer;

(2) from a partnership to a partner that relates to the percentage share of the income or loss of the partnership that the partner holds, providing the property had not been transferred.

If the transfer of eligible property is a result of one of the following, no RST is payable on the transfer:

(1) from a person to a partnership on the creation of the partnership, providing the value of the consideration paid for the property does not exceed the value of the partnership interest received by the person

(2) from a partnership to a partner if that partner had originally transferred the property to the partnership on its creation.

These rules appear to limit the value of the property that may be transferred into a partnership without the payment of tax to the value of the partnership interest that is received in exchange. That, decidedly, was not a position taken in current RST Sales Tax Guide 210, *Partnerships* – and it may well be a new approach in Ontario. Finally, no tax is payable in respect of the transfer of an interest in a partnership from a partner to another person.

I - 1.5 Further Specifics

Given the complexity of the proposed new rules, taxpayers or advisors contemplating actual transactions should review them closely to determine whether the necessary requirements are met.

I - 1.6 Final Commentary

Ontario's new approach is a giant step forward. While only time will reveal all the issues that will arise from this new approach, Ontario taxpayers should generally be ecstatic at the modernization of these rules, and their increased availability to corporate and partnership transactions.

At this point, Ontario has requested comments by September 3, 2004 (a date that has already past for readers of this paper). The timeframe was perhaps somewhat unrealistic given the summer holidays that most taxpayers and tax advisors would be expected to take, and given the time generally required to disseminate information on changes like these. Notwithstanding this, the proposed regulations are expected to be finalized sometime later in the fall, and until the regulations come into force, the current RST regulations apply.

The Ministry has noted that the effective date for the proposed amendments will be July 20, 2004 – the release date of the draft regulation.

I - 2 NEW GST POLICIES ON "CARRYING ON BUSINESS"

For some time now, the Canada Revenue Agency ("CRA") has had a bee in its bonnet when it comes to U.S. and other "foreign" businesses with Canadian operations.

Most recently, the CRA has articulated its angst in the form of draft GST Policy P-051R2, *Carrying on Business in Canada* (as released in September 2004, the "Draft Policy").

The Draft Policy will have big consequences for U.S. and other foreign businesses as it is expected to attempt to force many (especially foreign lessors) into the GST system wherever their operations have any substantial connection at all to Canada.

I - 2.1 How the GST Framework Works

As many readers will know, the GST is Canada's federal value-added taxing system, and applies a 7% federal tax to all payments for goods, whether sold or rented. Thus a business that is supplying goods in Canada would generally be required to register for the GST, and to begin charging and collecting the GST from its customers, and then remitting GST to the CRA. In some instances, an additional 8% HST can apply, bringing the total value-added tax to 15%.

Historically, non-residents have been able to avoid the GST (and HST) system altogether by ensuring that whatever they may be doing in Canada, they are not "carrying on of a business in Canada".

That is because so long as a non-resident does *not* carry on business in Canada, special rules in sections 143 and 240 of the *Excise Tax Act* – which is Canada's GST legislation – exempt the non-resident from having to register for the GST, and from having to charge, collect and remit the GST.

Historically, non-residents were also the beneficiary of some fairly clear guideposts for staying on the far side of the carrying on business line, and it was common to advise non-residents that so long as lease contracts were all signed and concluded outside of Canada, and no bank accounts or other physical operations were maintained in Canada, that the operations would not require registration for the GST.

I - 2.2 Historical Position

The concept of "carrying on business" is not defined in the *ETA*, and falls to be determined by the facts of the situation.

A number of legal tests have also been developed, largely from historical jurisprudence under the *Income Tax Act*.

That jurisprudence suggests that to determine whether a person is "carrying on business" in Canada requires a factual-based analysis, focused on a couple of primary factors, and an inexhaustive set of secondary factors.[10] The two primary factors being:

(a) the place where the contract for the supply was made; and
(b) the place where the operations producing profits in substance take place.

In terms of the "place where a contract is made", the jurisprudence generally accepts that the important elements of the contract are its offer, and its subsequent acceptance, and that the place the contract is "accepted" is the place where the contract for the supply is made.

Significantly, the CRA in its GST Memoranda Series 2.5 (*Non-Resident Registration*, June 1995) also confirmed that the concept of "carrying on business" ought to focus on the two primary factors above, with the place where a contract is concluded being the "place where the offer is accepted".[11]

Figure 5: ***CRA's "Place of Operations" Criteria***

The CRA has established the following indicia for determining whether Canada is the "place of operations" of a non-resident (such that the non-resident will be viewed as "carrying on business" in Canada for purposes of the *ETA*:

- the place where agents or employees of the non-resident are located;
- the place of delivery;
- the place of payment;
- the place where purchases are made;
- the place from which transactions are solicited;
- the location of an inventory of goods;
- the place where the business contracts are made;
- the location of a bank account;
- the place where the non-resident's name and business are listed in a directory;
- the location of a branch or office;
- the place where the service is performed; and
- the place of manufacture or production.

Source: Technical Information Bulletin B-090
GST/HST and Electronic Commerce (July 2002)

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10 In the GST context, the CRA has indicated that "other factors" would include: (a) the place where the goods were delivered, (b) the place where the payment was made, (c) the place where the goods in question were manufactured, (d) the place where the orders were solicited, (e) the place where the inventory of the goods is maintained, (f) the place where the company maintains a branch or office, (g) the place where agents or employees, who are authorized to transact business on behalf of the non-resident person, are located, (h) the place where bank accounts are kept, (i) the place where back-up services are provided under the contract, and (j) the place in which the non-resident person is listed in a directory: see GST Memoranda GST 200-1-1, Chapter 2, Section 2.5 (May 1999).

11 For further reference to the meaning of "carrying on business", see: W. Jack Millar and Dennis A. Wyslobicky, *Cross-Border Transactions: Retail Sales Tax and Non-Resident Vendors* (September 1986) A paper presented at the 1986 CICA Annual Symposium (Toronto: CICA, 1986), at pages 8 through 30.

Based on these two factors, the mere advertising of products for sale in Canada (invitations to treat and not formal "offers for sale") has not generally been regarded as sufficient activities to result in the carrying on business in Canada.

I - 2.3 Recent Policy Changes

More recently, the CRA has been detracting from its focus on two "primary factors" referred to above, in favour of a more general "place of operations" approach, first set out in a July 2002 Technical Information Bulletin B-090: *GST/HST and Electronic Commerce*.

The upshot of this new approach is that the CRA has effectively done away with the "place the contract was made" criteria – relegating it to just one of a number of criteria that are relevant to determining the "place of operations" (see Figure 5) – and thereby increasing the uncertainty of non-residents attempting to understand whether they are required to register for the GST.[12]

It is apparent that these changes were developed by the CRA because of some concerns that electronic commerce-type businesses might be gaining an unfair advantage in Canada (i.e., relative to their "brick and mortar" competitors, it was much easier to avoid registration for the GST).

I - 2.4 Draft Policy P-051R

Most recently, the CRA's evolution of thought appears to have now been crystallized in draft GST Policy P-051 R2, which states quite simply:

[12] Previously it was fairly easy to provide a non-resident with the opinion that the non-resident was not "carrying on business" in Canada: Step 1: Ensure that all contracts are accepted outside of Canada, and that there are no agents with the authority to accept them in Canada; Step 2: Ensure that most of the other factors listed by the CRA (and referred to above) were minimized.

Now the situation is much less clear, and that makes is much more difficult to advise a non-resident that it is not "carrying on business" in Canada, and therefore relieved from registering for the GST.

ISSUE:

At issue is whether or not a non-resident person is carrying on business in Canada for GST/HST purposes. This determination is important for purposes of determining if the non-resident is required to register for GST/HST purposes and to collect GST/HST on its taxable supplies.

DECISION:

The phrase "carrying on business in Canada" is not defined in the Act. The determination of whether a person is carrying on business in Canada for GST/HST purposes is a question of fact requiring consideration of all relevant facts. This policy statement sets out factors and principles to be considered in making such a determination, be it in a traditional or electronic commerce environment.

Draft P-051R2 also establishes guidelines similar to those already in place in TIB B-090R (See Figure 5).

While the Guidelines are more or less "old new", the Draft Policy does provide a number of examples which tend to illustrate the extent to which the CRA will be looking to non-residents to force GST registration.

Readers are commended to review the same.

Suffice it to say that the Draft Policy now seeks to change what was historically the established position under the jurisprudence, and will force many non-residents engaged in what they might have historically considered to be "business outside of Canada", to both re-evaluate that conclusion, and potentially enter the GST system.

Figure 6: ***CRA "Guidelines" in P-051 R2***

Guidelines

The factors that will be considered in determining whether a non-resident person is carrying on business in Canada for GST/HST purposes in a particular situation include:

- the place where agents or employees of the non-resident are located;
- the place of delivery;
- the place of payment;
- the place where purchases are made or assets are acquired;
- the place from which transactions are solicited;
- the location of assets ("profit making apparatus") or an inventory of goods;
- the place where the business contracts are made;
- the location of a bank account;
- the place where the non-resident's name and business are listed in a directory;
- the location of a branch or office;
- the place where the service is performed; and
- the place of manufacture or production.

The importance or relevance of a given factor in a specific case depends on the nature of the business activity under review, and, as always, the particular facts and circumstances of each case.

Source: Draft GST Policy P-051 R2
Carrying on Business in Canada (Circa September 2004)

I - 3 CORPORATE NICETIES & THE APPLICATION OF COMMODITY TAXES [13]

One thing that tax advisors can sometimes forget is the importance of the finer points of the legal niceties of their clients' businesses.

Three recent cases illustrate some of the dangers that can be lurking for advisors and clients that fail to heed the legal requirements for the businesses that they choose to carry on.

I - 3.1 Netupsky Case – What is a Valid Resignation ?

All readers will know that directors can be face significant liabilities for a corporation's failure to remit taxes.

While the main income tax provision is subsection 227.1(4) of the *Income Tax Act* ("ITA"), section 322 of the *Excise Tax Act* ("ETA") and subsection 43(5) of the *RSTA* govern the situation and establish director's liability for GST and Ontario RST purposes.

Under these rules, as in the income tax context, "director's liability" is not open ended and there are some defences (e.g., the defence of "due diligence"), as well as some "limitations".

One of the more important of these limitations is found is the provision that limits the time in which an assessment may be brought against a director for director's liability to "two years": see subsections 323(5) of the ETA, 227.1(4) of the ITA and 43(5) of the RSTA. That is, a director will not be liable for the corporation's failure to remit tax more than two years after they cease to be a director.

The issue often arises as to what is a valid resignation, and when does it become effective ?

In *Netupsky v. Her Majesty the Queen*[14] the Tax Court of Canada set out the legal requirements for a valid director's resignation.

I - 3.1(a) The Facts

Mr. Netupsky was the president and sole director of his company. He resigned as a director in 1995 by delivering a written resignation to the registered office of the company. The resignation was

[13] The author acknowledges the assistance of Wendy A. Brousseau in the preparation of this section. Wendy is an associate with Millar Kreklewetz LLP, and practices within the Commodity Tax, Customs & Trade areas.

[14] January 21, 2003 (Docket: 2000-4608-GST(G))

deposited in the company's minute book, on December 14, 1995 – which was more than two years before he was assessed as a director. However, as is often the case, the appropriate notice was not filed with the B.C. corporate registry, nor was the resignation entered into the company's Register of Companies.

When it came time to assess for director's liability, the CRA first conducted a search of the B.C. provincial corporate registry and, finding Mr. Netupsky to be a director, assessed him.

At Court, the CRA took the position that Mr. Netupsky was still a director, and that the resignation was not valid since the corporate search (and the company's Register of Directors) indicated that Mr. Netupsky was still listed as a director.

I - 3.1(b) *The Tax Court's Decision*

Fortunately for Mr. Netupsky, and other owner-managers in the same general position – the Tax Court found otherwise.

On reviewing the facts before it, the Tax Court ruled that the resignation was in fact valid since it was done in the manner prescribed in the B.C. *Company Act,* which, at the relevant time, provided as follow:

> 154. (1) A director ceases to hold office … when he
>
> (a) dies or resigns …
>
> (2) Every resignation of a director becomes effective at the time a written resignation is delivered to the registered office of the company or at the time specified in the resignation, whichever is later.[15]

The Tax Court found that under the corporate statute, all that was required for a director to effectively resign was delivery of a written resignation to the registered office of the company – which was clearly established by Mr. Netupsky. Accordingly, the effectiveness of a director's resignation did not depend on whether a notice of resignation was filed with the Registrar of Companies.[16] The Tax Court thus found that Mr. Netupsky's resignation was valid and since it was more than two years before the assessment, and he escaped liability !

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[15] This provision is now found in section 130 of the *Company Act*.

[16] While such notice of Mr. Netupsky's resignation was required to be filed with the provincial corporate registry, this was a matter for the corporation since under the B.C. *Company Act*, the corporation, rather than the director, was required to file a notice of resignation with the Registrar of Companies.

I - 3.1(c) *Commentary*

The *Netupsky* case underscores the importance of ensuring that a director's resignation is tendered, to the corporation, as soon as possible upon the decision to resign be made. That will start the clock ticking, in most cases, and help minimize the ultimate liability that faces directors in these situations.

While Mr. Netupsky was obviously able to rely on some of the technical requirements in his case, the case also illustrates the importance, following a resignation, of attempting to comply with all of the corporate and other legal and quasi-legal requirements of doing so. Understanding and abiding by the resignation requirements in basic corporate governance legislation is just the first step in that process. And in this regard, provisions similar to section 154 of the B.C. *Company Act* (regarding the resignation of directors) are found in section 108 of the *Canada Business Corporations Act* ("CBCA"), and section 121 of *Ontario Business Corporations Act* ("OBCA").[17] [18]

While the Tax Court's decision in our view correctly states the legal requirements for a valid director's resignation, the result of the decision can generally be viewed as in direct contrast to the manner in which the CRA and Ontario proceed.

I - 3.2 The Dion Case – Cancelling A GST Registration is Important

In *Dion v. Her Majesty the Queen*,[19] the taxpayer unwittingly left its GST registration exist even though she was of the view that she was a small supplier, and stopped collecting GST on her sales. The Court found that a GST obligation continued, to the taxpayer's detriment.

I - 3.2(a) *The Facts*

Ms. Dion operated a salon for some time, but closed it in mid 1990 to begin operating, on a smaller scale, out of her home. At that time, she applied for GST registration, but for some reason or another she was given two GST registration numbers, in error. A few months later, and once realizing that her annual revenues would be less than the $30,000 per year required for "mandatory GST registration", Ms. Dion cancelled her GST registration – or at least thought she did.

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[17] Both of the OBCA and CBCA provisions provide that "a resignation of a director becomes effective at the time a written resignation is sent to the corporation, or at the time specified in the registration, whichever is later.

It should be noted however, that subsection 119(2) of the OBCA, prohibits a director named in the articles to resign unless a successor is appointed or elected.

[18] For some other cases on this subject, see also *Perri v. M.N.R.*, 95 D.T.C. 5417 (FCTD), *R v. Giglio*, 98 D.T.C. 1961 (TCC), *Binavince v. M.N.R.*, 91 D.T.C. 1225, and *Cybulski v. M.N.R.*, 88 D.T.C. 1531.

[19] *Dion v. Her Majesty the Queen,* [2002] TC.J. No. 419 (GST)I.

What she did do, however, was cancel one of the GST registration numbers, but not the other.

Over the years, Ms. Dion received more than 35 notices from the CRA, each time demanding that she file GST returns – and all triggered by the one GST registration that remained in effect. For some reason or another, Ms. Dion chose to ignore the notices – perhaps believing that since she had cancelled her one GST registration, the notices had to be in error.

I - 3.2(b) *The Tax Court's Decision*

The Tax Court was left to determine whether Ms. Dion, being registered for the GST during the period in question, owed the CRA the GST that should have been charged on her business revenues.

In quite a draconian result, the Tax Court found that despite the fact that Ms. Dion should not have received two GST registrations, she had remained GST registered throughout the period in question, and accordingly should have been charging, collecting and remitting GST on her salon business.

The fact that Ms. Dion was still a "small supplier" did not matter, as she was in fact "registered" during the period in question, and that required her to charge GST.

The Court also noted that Ms. Dion could not have cancelled her first registration when she did, as paragraph 242(2)(b) of the *ETA* forced registered persons to be registered for at least one year before they may cancel their registration.

I - 3.2(c) *Commentary*

It appears that when one registers for the GST, it may be a bit like a marriage: harder than you think to get out of than you would like to admit. Tax advisors ought to be sure to impress on their clients that when registered for the GST, and wanting to get out of the GST system, some positive steps ought to be taken to do so, lest unintended results follow.

I - 3.3 Amerey et al v. Her Majesty the Queen – Paying Attention to Corporate Status

In the *Amerey v. The Queen*,[20] the taxpayers were again assessed personally for a business's unremitted GST, this time on the basis that the corporation that they thought they were operating through, was not legally alive, and therefore the GST fell to be accounted for by the two principals personally.

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20 *Amerey et al v. Her Majesty the Queen,* [2003] T.C.J. No. 672 (GST)I.

I - 3.3(a) *The Facts*

The taxpayers were also shareholders of the business, Amerey Enterprises Inc. (the "Corporation"), which had been struck off the Alberta corporate registry in 1993. The business however, was carried on in the same manner. The Corporation was eventually revived in 2000, retroactive to December 31, 1995.

The two shareholders took the position that since the Corporation was revived retroactively, it was the Corporation that was carrying on business at all times, rather than the taxpayers personally. (This may have been a bit of an inconsistent position, since it came to light that for income tax purposes, the taxpayers had accepted an earlier favourable audit on the basis that they were operating as partners).

The issue before the Court, therefore, was whether the Appellants or the Corporation made the supplies in issue between January 1, 1996 to December 31, 2001.

I - 3.3(b) *The Tax Court's Decision*

The Tax Court again found against the taxpayers, and determined that the two principals were carrying on business as partners, and therefore liable for any unremitted GST.

I - 3.3(c) *Commentary*

Once again it would appear that the Tax Court is forcing advisors and their clients to ensure that a blind eye is not taken to the world around them. If they choose to operate through a separate legal entity like a corporation, or even in "partnership", they must take care to ensure that the legal niceties of that relationship are observed. In the absence of "dotting those i's, and crossing those t's", ugly things can happen – as the two principals in Amerey found out the hard way.

I - 3.4 *Zaborniak* - Derivative Assessments; More Uncertainty

In *Zaborniak v. Her Majesty the Queen,*[21] the Tax Court has thrown more uncertainty into the issue of whether or not a director can defend a director's liability assessment by arguing the substantive merits of the corporation's underlying GST case.

I - 3.4(a) *The Facts*

A brother and sister were assessed as directors under section 323 of the ETA, and along with another (third) sibling, were the sole directors of a corporation.

[21] *Zaborniak v. Her Majesty the Queen*, [2004] T.C.J. No. 412 (T.C.C) (GST)I.

The corporation had failed to file GST returns and failed to remit GST.

The issue was whether a director assessed pursuant to section 323 could challenge the underlying assessment of the corporation – i.e., whether a valid defence to a director's liability assessment was that the corporation's assessment was wrong.

I - 3.4(b) The Tax Court's Decision

In a nut shell, the Tax Court found that the directors could not challenge the substantive merits of the corporation's case.

The Court found that the assessment against the corporation, pursuant to subsection 299(4) of the ETA was valid and binding, subject to being vacated on objection or appeal, which could only be done by the person who had been assessed (which in this case was the corporation). In this instance, the Court found that the statutory language in section 323 was clear and did not allow a director to challenge the corporation's assessment (which pursuant to paragraph 323(2)(a) was deemed a judgment debt).

The Court did, however, acknowledge that based on the decision of the Federal Court of Appeal in *Gaucher,*[22] there have been conflicting decisions of the Tax Court on this issue. Based on *Gaucher,* many have suggested, including Associate Chief Justice Bowman, that it is open to a taxpayer who has been assessed derivatively under section 323 of the ETA to challenge the underlying assessment against the corporation even if the corporation has failed to do so.[23]

Specifically, in *Gaucher*, the Federal Court of Appeal held that a derivative assessment under section 160 of the *Income Tax Act* could challenge the primary assessment. In that case, the Federal Court of Appeal stated that,

> It is a basic rule of natural justice that, barring a statutory provision to the contrary, a person who is not a party to litigation cannot be bound by a judgment between other parties. The appellant was not a party to the reassessment proceedings between the Minister and her former husband.
>
> …
>
> It seems to me that this approach fails to appreciate that what is at issue are two separate assessments between the Minster and two different taxpayers. Once the assessment against the primary taxpayer is finalized, either because the primary taxpayer does not appeal the assessment, or the assessment is confirmed by the Tax Court (or a higher court if further appealed), that assessment is final and binding between the

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22 *Gaucher v. Her Majesty the Queen*, [2000] F.C.J. No. 1869 (F.C.A.).

23 *Wiens v. Her Majesty the Queen*, [2003] G.S.T.C. 121 at par. 5 (T.C.C.) (GST)I. See also, *Lau v. Her Majesty the Queen,* [2003] G.S.T.C. 1, *Elias v. Her Majesty the Queen*, 2002 D.T.C. 1293 (T.C.C.) (IT)G; *Marceau v. Her Majesty the Queen*, [2003] G.S.T.C. 51 (T.C.C.) (GST)I., and *Cochran v. Her Majesty the Queen*, (2002) G.S.T.C. 2 (T.C.C.) (GST)G.

> primary taxpayer and the Minister. An assessment issued under subsection 160(1) against a secondary taxpayer cannot affect the assessment between the Minister and the primary taxpayer.
>
> By the same token, since the secondary taxpayer was not a party in the proceedings between the Minister and the primary taxpayer, she is not bound by the assessment against the primary taxpayer. The secondary taxpayer is entitled to raise any defence that the primary taxpayer could have raised against the primary assessment.

The Tax Court decisions that have found that a director cannot challenge the corporation's underlying assessment have done so primarily on the basis that a director will normally be in a position to influence the corporation's decision to appeal its assessment.[24]

With all due respect, however, such may no always be the case. For instance where a trustee or receiver is appointed, generally directors are denuded of their powers.

Accordingly, based on the Federal Court of Appeal's reasoning in *Gaucher* and our view that the deeming provision in subsection 299(4), which deems an assessment to be valid and binding, only deems the assessment to be binding between the person assessed and the Minister as well as considerations of fairness and fundamental justice, a director should be entitled to challenge the assessment against the corporation.

Until the issue is clearly resolved by the Federal Court of Appeal however, there remains doubt on the issue, particularly since the Tax Court seems to have some judges of differing views.

[24] For instance in the *Maillé* case, the director was the sole director of the corporation. In *Zaborniak* the Court stated that the directors assessed "had the opportunity to influence the corporation's decision whether to appeal".

PART II – COMMODITY TAX BUILDING BLOCKS

II - 1 GST OVERVIEW

Canada's federal value-added taxing system is called the Goods and Services Tax (the "GST"), and is provided for in Part IX of the *Excise Tax Act* (the "*ETA*").

While commonly considered a single tax, the GST is actually imposed under three separate taxing divisions. Each taxing Division is aimed at a distinctly different type of transaction. Together, the three taxing Divisions create a comprehensive web of taxation, whose basic design is to tax virtually every domestic supply of goods, services, and intangibles, [25] as well as most goods,[26] services, and intangibles "imported" to Canada. (See Figure 1).

Figure 1: ***GST/HST – ETA Taxing Divisions & Schedules***

DIVISION I:	Interpretation
DIVISION II:	**GST on Taxable Supplies Made In Canada**
DIVISION III:	**GST on Imported Goods**
DIVISION IV:	**GST on Imported Taxable Supplies**
DIVISION IV.1:	HST on Imported Supplies
DIVISION V:	Collection & Remittance of Division II Tax
DIVISION VI:	Rebates
DIVISION VII:	Miscellaneous
DIVISION VIII:	Administration & Enforcement
DIVISION IX:	Transitional Provisions - GST (1991)
DIVISION X:	Transitional Provisions – HST (1996)
DIVISION XI:	Tax-Included Pricing Rules
Schedule V:	Exempt Supplies
Schedule VI:	Zero-rated Supplies
Schedule VII:	Non-Taxable Importation's – GST
Schedule VIII:	HST Tax Rates
Schedule IX:	HST Place of Supply Rules
Schedule X:	Non-Taxable Importation's – HST

Under Division II of the *ETA*, for example, GST is imposed on domestic supplies, which are referred to as "taxable supplies made in Canada". [27] In turn, Division III imposes GST on most imported goods,[28] while Division IV imposes GST on a number

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25 For "domestic" supplies, the principal exceptions are goods, services, or intangibles enumerated in Schedules V or VI of the *ETA*, which provide for certain "exempt" and "zero-rated" supplies, respectively.

26 Schedule VII of the *ETA* enumerates certain goods that, when imported to Canada, may be imported on a "non-taxable" basis.

27 See subsection 165 of the *ETA,* which provides as follows:

> 165.(1) Imposition of goods and services tax — Subject to this Part, every recipient of a taxable supply made in Canada shall pay to Her Majesty in right of Canada tax in respect of the supply calculated at the rate of 7% on the value of the consideration for the supply.

28 See section 212 of the *ETA*, which provides as follows:

> 212. Imposition of goods and services tax — Subject to this Part, every person who is liable under the Customs Act to pay duty on imported goods, or who would be so liable if the goods were subject to duty, shall pay to Her Majesty in right of Canada tax on the goods calculated at the rate of 7% on the value of the goods.

of "imported taxable supplies" – which are defined to include certain services and intangibles acquired outside of Canada, but consumed, used or enjoyed in Canada.[29]

On the other hand, the *ETA* also contains provisions aimed at relieving GST from most goods, services, and intangibles *exported* from Canada. This is accomplished through extensive "zero-rating" provisions, enumerated largely in Part V of Schedule VI of the *ETA*. This approach is consistent with the other aim of the *ETA*, which is to remove the GST from any Canadian goods, services or intangibles competing in the international markets.

What all of this also means is that persons engaged in even the simplest of corporate transactions often find themselves facing a number of very complex issues, sometimes resulting in the imposition of GST under one *or more* of Divisions II, III or IV, and sometimes, with proper structuring, resulting in the imposition of no GST whatsoever. It should also be noted, with the fairly recent addition of an 8% "harmonized sales tax" ("HST") in certain of Canada's Atlantic provinces,[30] that businesses with cross-border exposures in those provinces will now see that what was once a 7% risk, is now a 15% risk.

II - 1.1 Division II & "Taxable Supplies Made in Canada"

When people speak of the GST, they are most often referring to the GST that is imposed by section 165 of the *ETA,* which is a Division II tax, applying to "every recipient[31] of a taxable supply made in Canada". While imposing a tax only on domestic supplies (i.e., taxable supplies "made in Canada"), Division II affects a large number of cross-border transactions, including supplies made in Canada by registered[32] non-residents,[33] unregistered non-residents who carry on business in Canada, and supplies (..continued)

Section 212 must be read in the context of various definitions and rules in the *Customs Act* and *Customs Tariff,* as well as Schedule VII of the *ETA*: see again note 3, *supra.*

29 See section 218 of the *ETA,* which provides as follows:

> 218. Imposition of goods and services tax — Subject to this Part, every recipient of an imported taxable supply shall pay to Her Majesty in right of Canada tax calculated at the rate of 7% on the value of the consideration for the imported taxable supply.

Section 218 must be read in the context of a complex definition of "imported taxable supply", found in section 217.

30 The HST was introduced on April 1, 1997, effectively adding-on an additional 8% provincial component to the GST otherwise charged with respect to GST transactions affecting the harmonized provinces of Nova Scotia, New Brunswick and Newfoundland & Labrador (the "Harmonized Provinces"). The substantive taxing provisions imposing the HST were, at that time, fully incorporated into the GST legislation found in Part IX of the *ETA,* making the HST fully harmonized with the GST.

31 A recipient is defined in subsection123(1) of the *ETA* to be the person liable to pay for the supply under a written or oral agreement, or as a matter of law. Special rules apply where no consideration is payable for the particular supply.

32 "Registered" is used to refer to persons who are registered for the GST in accordance with the applicable requirements in the *ETA* (found in subdivision d of Division V). Note that the term "registered" is used in contra-distinction to the term "registrant". While "registered" refers to a person who is actually registered for the GST, the term "registrant" refers to a person "who is registered, or who is *required* to be registered": see subsection 123(1) of the *ETA*.

which are drop-shipped in Canada on behalf of unregistered non-residents. Division II can also affect certain goods, services and intangibles seemingly exported from Canada.

There are a number of general rules governing when Division II tax will apply, and when a non-resident supplier will be required to "register" for the GST, and enter into the GST system, some of which are discussed below.

II - 1.1(a) *What is a "Taxable Supply" under Division II ?*

Before attempting to determine whether a supply is made "in Canada" or "outside Canada" – and therefore "inside" or "outside" the scope of the Division II tax imposed by section 165 – an appropriate "first step" would be determining whether the particular supply is "taxable", or whether it is "exempt" or "zero-rated".[34]

A "taxable supply" is defined in sectionsubsection 123(1) of the *ETA* to be a supply that is made in the course of a "commercial activity". Since "commercial activity" is defined quite broadly, a taxable supply would generally include most supplies made in the course of a business, or in an adventure or concern in the nature of trade. Significantly, however, a "taxable supply" specifically excludes the making of those "exempt" supplies that are enumerated in Schedule V of the *ETA*.[35]

II - 1.1(b) *Supplies Made "in Canada"*

If a supply is "taxable", one can then proceed to determine whether that supply is made "in Canada" or "outside Canada".[36] Section 142 of the *ETA* contains a number of general rules for determining when a supply is made "in Canada", usually referred to as the "place of supply" rules. Under these "place of supply" rules, one is theoretically able to determine how any supply connected to Canada will be treated for GST purposes. For example, if the transaction involves a "sale of goods", the supply would be

(..continued)

33 Like under the *Income Tax Act*, the term "non-resident" is, for GST purposes, used in contra-distinction to the defined term "resident": see section 123(1). For the *ETA*'s rules on residency, see section 132.

34 This is because the Division II tax only applies to "*taxable* supplies made in Canada".

35 A "taxable" supply will also include the sorts of "zero-rated" supplies that are enumerated in Schedule VI of the *ETA*, since the concept of a "taxable supply" includes "zero-rated" supplies: see the definitions of "commercial activity", "exempt supply", and "taxable supply", all found in subsection 123(1) of the *ETA*. The difference between the two is simply that a "taxable" supply is taxed at a GST rate of 7%, while a "zero-rated" supply is taxed at a GST rate of 0% – effectively removing the GST from the zero-rated supply altogether.

36 In reviewing the general and specific rules discussed *infra*, and in determining whether a particular taxable supply is made "in Canada" or "outside Canada", remember the significance of these rules: (1) Where a taxable supply is made "inside" Canada it will be taxable under Division II, and not generally taxable under any other provision in the *ETA* (although there are some exceptional situations where double-tax can occur); (2) If, on the other hand, the taxable supply is made "outside Canada", it will be outside the purview of Division II tax, and would only be subject to GST, if at all, under Division III (imported goods) or Division IV (imported services and other intangibles).

considered to have been made "in Canada" if the goods are "delivered or made available" to the purchaser "in Canada". Other rules apply for other types of supplies (e.g., supplies of leased goods, services, intangibles or real property).

II - 1.1(c) Special Non-Residents Rule

The "place of supply rules" found in section 142 must always be read in conjunction with a number of other rules which affect the determination of whether a particular supply is made "in Canada" for purposes of the Division II tax. For non-residents, the most important of these rules is found in section 143 of the *ETA*, which we will refer to as the "special non-residents rule".

The special non-residents rule deems all supplies of property and services made in Canada by non-residents to be made *outside* Canada, *unless* (a) the supply is made in the course of a business carried on by the non-resident in Canada, or (b) the non-resident was registered for the GST at the time the supply was made. The effect of this rule is to make the *ETA*'s general "place of supply" rules inapplicable if the transaction involves a supply made by "unregistered non-residents", not carrying on business in Canada. When the special non-residents rule applies, it operates to deem any supplies made by the non-resident to be completely "outside" the GST system. That means that the non-resident would remain completely exempt from any requirements to register for the GST, or to charge and collect the GST on its supplies made to Canadians.[37]

The potential significance of this rule makes the meaning of terms like "non-resident", "registered", and "carrying on business in Canada" quite important.

II - 1.1(d) Residents & Non-Residents

While a complete discussion is outside the scope of this paper, the *ETA* does have rules regarding the meaning of "non-resident" and "resident". For example, section 132 of the *ETA* provides that a corporation will be considered a "resident" of Canada if it has been "incorporated" or "continued" in Canada, and not continued elsewhere. A corporation will also be considered a "resident" if it satisfies the common law tests for residency namely, if the corporation's "central management and control" is located in Canada.

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37 Note the distinction between charging, collecting and remitting the Division II tax on supplies made by the non-resident "in Canada", and the non-resident's obligation to pay GST at the border on goods imported to Canada under Division III (discussed *infra*).

While this might suggest that only corporations incorporated or continued outside of Canada – or with "central management and control" in Canada – will qualify as "non-residents", the *ETA's* "permanent establishment" rules can also affect that determination as well.

II - 1.1(e) *Permanent Establishments*

Section Subsection 132(2) of the *ETA* deals with "permanent establishments" for non-residents, and provides that where a non-resident person has a permanent establishment in Canada, the non-resident shall be *deemed* to be resident in Canada in respect of, but only in respect of, activities that are carried on through that permanent establishment. The effect of this rule is to *exclude* the "now-deemed-resident" from the application of the special non-residents rule in section 143 – although that exclusion would only relate to supplies carried on through the permanent establishment.[38] This means that a non-resident with a Canadian permanent establishment might (unhappily) find that some of its Canadian business activities have succeeded in drawing it *into* the GST system, and requiring it to take positive steps to register for the GST, and to begin charging, collecting, and remitting the GST to the Canada Customs and Revenue Agency (the "CCRA"). Furthermore, and to the extent the non-resident becomes GST registered, the special non-residents rule would no longer be available to any of the non-resident's activities.

In many respects, the significance of having a "permanent establishment" for GST purposes is not unlike the significance of having one for purposes of the *Income Tax Act* – as read in context of many of Canada's international treaties.

II - 1.1(f) *Carrying on Business*

As previously indicated, the other main requirement for use of the "non-residents rule" in section 143 is that the non-resident must not be "carrying on business" in Canada. The concept of "carrying on business" is not defined in the *ETA*, and falls to be determined by the facts of the situation. A number of legal tests have also been developed, largely from jurisprudence under the *Income Tax Act*. As most readers will already appreciate, that jurisprudence suggests that to determine whether a person is "carrying on business" in Canada requires a factual-based analysis, focused on a couple of primary factors, and an inexhaustive set of secondary factors.[39] The two primary factors being:

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38 A logical conclusion, however, might be that since a permanent establishment exists, for at least one purpose, the non-resident is actually carrying on business in Canada, which would deprive the non-resident from use of the section 143 rule in its own right.

39 In the GST context, the CRA has indicated that "other factors" would include: (a) the place where the goods were delivered, (b) the place where the payment was made, (c) the place where the goods in question were manufactured, (d) the place where the orders were solicited, (e) the place where the inventory of the goods is maintained, (f) the place where the company maintains a branch or office, (g) the place where agents or employees, who are authorized to transact business on behalf of the non-resident person, are located, (h) the place where bank accounts are kept, (i) the

(a) the place where the contract for the supply was made; and

(b) the place where the operations producing profits in substance take place.

Figure 2: ***CRA's "Place of Operations" Criteria***

The CRA has established the following indicia for determining whether Canada is the "place of operations" of a non-resident (such that the non-resident will be viewed as "carrying on business" in Canada for purposes of the *ETA*:

- the place where agents or employees of the non-resident are located;
- the place of delivery;
- the place of payment;
- the place where purchases are made;
- the place from which transactions are solicited;
- the location of an inventory of goods;
- the place where the business contracts are made;
- the location of a bank account;
- the place where the non-resident's name and business are listed in a directory;
- the location of a branch or office;
- the place where the service is performed; and
- the place of manufacture or production.

Source: Technical Information Bulletin B-090
GST/HST and Electronic Commerce (July 2002)

In terms of the "place where a contract is made", the jurisprudence generally accepts that the important elements of the contract are its offer, and its subsequent acceptance, and that the place the contract is "accepted" is the place where the contract for the supply is made.

Significantly, the CCRA in its GST Memoranda Series 2.5 (*Non-Resident Registration*, June 1995) has confirmed that the concept of "carrying on business" ought to focus on the two primary factors above, with the place where a contract is concluded being the "place where the offer is accepted".[40] Based on these two factors, the mere advertising of products for sale in Canada (invitations to treat and not formal "offers for sale") has not generally been regarded as sufficient activities to result in the carrying on business in Canada.

More recently, however, the CCRA has detracted from its focus on two "primary factors" referred to above, in favour of a more general "place of operations" approach, set out in a July 2002 Technical Information Bulletin B-090: GST/HST and Electronic Commerce.

The upshot of this new approach is that the CCRA has effectively done away with the "place the contract was made" criteria – relegating it to just one of a number of criteria that are relevant to

(..continued)

place where back-up services are provided under the contract, and (j) the place in which the non-resident person is listed in a directory: see GST Memoranda GST 200-1-1, Chapter 2, Section 2.5 (May 1999).

[40] For further reference to the meaning of "carrying on business", see: W. Jack Millar and Dennis A. Wyslobicky, *Cross-Border Transactions: Retail Sales Tax and Non-Resident Vendors* (September 1986) A paper presented at the 1986 CICA Annual Symposium (Toronto: CICA, 1986), at pages 8 through 30.

determining the "place of operations" (see Figure 2) – and thereby increasing the uncertainty of non-residents attempting to understand whether they are required to register for the GST.[41]

It is apparent that these changes were developed by the CCRA because of some concerns that electronic commerce-type businesses might be gaining an unfair advantage in Canada (i.e., relative to their "brick and mortar" competitors, it was much easier to avoid registration for the GST).

One hopes that they have not sacrificed the certainty of the many to address a few specific (and unique) problem areas.

On the other hand, some of the examples in the E-Comm Bulletin are a bit surprising. For example, in the context of a supplier of downloadable audio files, the CCRA has confirmed its view that the following factors are not sufficient to establish the carrying on of a business in Canada:

1. Advertising that is directed at the Canadian market through a U.S. based web-site;
2. Concluding contracts in Canada; and
3. Processing payment in Canada.

Having said all of that, the bottom line here is that most non-residents will want to ensure that they are "unregistered" and "not carrying on business" in Canada – so as to ensure the proper application of the "non-residents rule".

Where they are "carrying on business" in Canada, or otherwise choose to "voluntarily register" (see below), the Division II tax will be payable, and the non-resident will have a contemporaneous requirement to register for the GST, and begin charging, collecting and remitting that Division II tax to the Canadian government.

II - 1.1(g) *Voluntary & Mandatory Registration Rules*

Special rules in section subsection 240(3) of the *ETA* permit persons engaged in a commercial activity in Canada, and certain non-residents with more limited ties to Canada, to voluntarily apply for GST registration.

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[41] Previously it was fairly easy to provide a non-resident with the opinion that the non-resident was not "carrying on business" in Canada: Step 1: Ensure that all contracts are accepted outside of Canada, and that there are no agents with the authority to accept them in Canada; Step 2: Ensure that most of the other factors listed by the CCRA (and referred to above) were minimized.

Now the situation is much less clear, and that makes is much more difficult to advise a non-resident that it is not "carrying on business" in Canada, and therefore relieved from registering for the GST.

These "voluntary registration" rules were broadened in 1996 and extend voluntary registration to non-residents who regularly solicit orders for the supply of goods to Canada, as well as non-residents who supply services to be performed in Canada, and intangibles that are to be used in Canada or otherwise related to Canada.

Note that while GST registration is sometimes voluntary, it is often mandatory and, subject to a special $30,000 "small supplier" rule, which would actually require most persons carrying on a business in Canada, and making taxable supplies in the course of a commercial activity to register.[42] (See Figure 3).

Figure 3: ***GST Registration***

Section 240 of the *ETA* provides for the GST Registration Rules. In terms of "mandatory" registration, subsection 240(1) provides as follows:

240.(1) **Registration required** — Every person who makes a taxable supply in Canada in the course of a commercial activity engaged in by the person in Canada is required to be registered for the purposes of this Part, except where

(a) the person is a small supplier;

(b) the only commercial activity of the person is the making of supplies of real property by way of sale otherwise than in the course of a business; or

(c) the person is a non-resident person who does not carry on any business in Canada.

Voluntary Registration is addressed in subsection 240(3), as follows:

(3) **Registration permitted** — An application for registration for the purposes of this Part may be made to the Minister by any person who is not required under subsection (1), (1.1), (2) or (4) to be registered and who

(a) is engaged in a commercial activity in Canada;

(b) is a non-resident person who in the ordinary course of carrying on business outside Canada

(i) regularly solicits orders for the supply by the person of tangible personal property for export to, or delivery in, Canada, or

(ii) has entered into an agreement for the supply by the person of

(A) services to be performed in Canada, or

(B) intangible personal property to be used in Canada or that relates to

(I) real property situated in Canada,

(II) tangible personal property ordinarily situated in Canada, or

(III) services to be performed in Canada;

(c) is a listed financial institution resident in Canada; or

(d) is a particular corporation resident in Canada

(i) that owns shares of the capital stock of, or holds indebtedness of, any other corporation that is related to the particular corporation, or

(ii) that is acquiring, or proposes to acquire, all or substantially all of the issued and outstanding shares of the capital stock of another corporation, having full voting rights under all circumstances,

where all or substantially all of the property of the other corporation is, for the purposes of section 186, property that was last acquired or

II - 1.1(h) *Why A Person Might Voluntarily Register*

Even if a non-resident successfully ensures that its business activities are not "carried on in Canada", there may be advantages to registering for the GST, such as the eligibility to recover the GST that they themselves pay on their inputs through claiming input tax credits ("ITCs"). This follows from section 169 of the *ETA*, which allows registered persons to claim ITCs, to the extent they were engaged in

[42] See section 240 of the *ETA*. Note that the most important exception to this general registration requirement is for "small suppliers", who would be exempted from registration provided their world-wide taxable supplies (including supplies by certain related persons) remained below $30,000 annually. For the precise rules regarding small suppliers, see subsection 123(1), and sections 148 and 148.1 of the *ETA*.

"commercial activities".[43] For example, for non-residents who are required to pay GST in order to carry on their activities (e.g., a non-resident selling goods into Canada on a delivered basis, who would be required to pay the GST at the border, under Division III – see *infra*), registration may provide an opportunity to fully recover the GST resulting from these activities. While there are other ways of unlocking the GST (e.g., ITCs under section 180), many times, simply registering for the GST is the easiest process to recover the GST.

On the other hand, with GST registration comes the administrative headaches of properly complying with one's GST obligations, which include regularly filing GST returns, ensuring that the GST is properly charged, collected and remitted, and a whole host of other obligations and considerations.

II - 1.2 Division III & "Imported Goods"

Division III is entitled *Tax on Importation of Goods,* and imposes tax on "every person who is liable under the *Customs Act* to pay duty on imported goods, or who would be so liable if the goods were subject to duty".[44] Accordingly, the Division III tax applies to most goods imported into Canada.

Somewhat like the situation under Division II, the non-resident supplier of the imported goods is under no obligation to charge or collect tax. On the other hand, since the "importer of record" is generally the one paying the Division III tax when clearing the imported goods at the border, a non-resident might well find itself on the "paying" end of the equation – but that would usually depend on what its "delivery terms" were. Thus, even if an unregistered non-resident has successfully shielded itself from any Division II tax obligations – perhaps because of the special non-residents rule in section 143, and the fact that it does not "carry on business" in Canada – the Division III tax can still apply to the goods being imported to Canada. Furthermore, and because there is no provision in the *ETA* creating a mutual exclusivity between Division II and Division III taxes, a potential for "double-taxation" does exist

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[43] See section 169 of the *ETA*, which provides in part as follows:

> 169.(1) General rule for credits — … [W]here a person acquires or imports property or a service … and, during a reporting period of the person during which the person is a registrant, tax in respect of the supply, importation … becomes payable by the person or is paid by the person without having become payable, the amount determined by the following formula is an input tax credit of the person in respect of the property or service for the period … .

The "formula" referred to generally pro-rates the GST recoverable based on the extent to which the person was engaged in commercial activities. If engaged completely in commercial activities, the person would be entitled to a full ITC. On the other hand, persons engaged completely in "exempt activities" would be precluded from claiming any ITCs, making the GST they pay unrecoverable, and a "hard cost".

[44] Section 214 provides that Division III tax shall be paid and collected under the *Customs Act* as if the tax were a customs duty levied on the goods. In turn, the *Customs Act* provides that the person who "reports" the goods in accordance with that Act (i.e., the importer of record), is jointly and severally liable, along with the owner, for the duties levied on the imported goods. Accordingly, Division III tax is often applied to persons not actually owning imported goods, but merely reporting them for customs purposes.

in these types of cross-border transactions, with both Division II and Division III tax being payable in some instances.

II - 1.2(a) *De facto Importer*

Proposed section 178.8 of the *ETA* is a complex provision aimed at addressing the de facto importer or "constructive" importer issue.

In simple terms, this issue occurs when goods are supplied outside Canada and subsequently imported into Canada with the supplier, rather than the recipient of the supply, acting as importer of record, and thus paying the Division III tax (and applicable duties) and claiming an ITC.

The CCRA takes the position that since the supplier is not the user or consumer of the goods in Canada nor importing the goods for the purpose of supplying them in the course of their commercial activities – which are prerequisites to ITC entitlement pursuant to paragraph subsection 169(1)(c) – they are not entitled to claim an ITC. Whether the CCRA's position is correct is debatable. On the other hand, the CCRA seems to have prorogued any further debate on the issue by causing the Department of Finance to propose these amendments.

The new section 178.8 is aimed at ensuring that it is *only* the recipient of the supply (i.e., the "de facto importer", in the CCRA's vernacular) that is entitled to an ITC for any GST paid at the border – under the CCRA's theory that only the "recipient" would be the user or the consumer of the goods in Canada.[45]

While this amendment would not normally impact a corporate reorganization, to the extent that property is imported to Canada as part of reorganization, these rules should be consulted.

II - 1.3 Division IV & "Imported Taxable Supplies"

The third taxing division under which GST might be payable is Division IV, which is entitled *Tax on Imported Taxable Supplies Other than Goods,* and which imposes tax on "every recipient of an iImported taxable supply".

Since an "imported taxable supply" is defined quite broadly, Division IV captures most transactions not otherwise taxable under Divisions II or III and, as indicated above, can catch a number of international

[45] The CRA's theory breaks down in the case of lessors, who might well be importing goods for the purposes of supplying them, by way of lease, to recipients in Canada. In that instance, the lessors would in fact be supplying the goods in Canada.

transactions involving services or intangibles. The rules defining "imported taxable supplies" are remarkably complex, and to the extent taxpayers are again involved in somewhat less than "exclusive" commercial activities, special attention should be paid to these rules. They will create a self-assessment tax in respect of amounts paid abroad for the use of intellectual property, and other intangibles or services, to the extent the services or intangibles that are being acquired for use otherwise than exclusively for commercial activities. In other words, if a Canadian resident is involved in some exempt activities, there may well be a Division IV self-assessment obligation imposed on it each time services or intangibles are acquired abroad.

II - 2 PST OVERVIEW

Currently, five of Canada's provinces levy a stand-alone provincial sales tax ("PST"). These provinces are British Columbia, Saskatchewan, Manitoba, Ontario and Prince Edward Island. Among the other provinces, Quebec has a provincial sales tax system (the "QST") that is *partially* harmonized with the GST, while Nova Scotia, New Brunswick and Newfoundland & Labrador have the aforementioned *fully* harmonized HST system.

Alberta, and Canada's three territories do not presently employ retail sales taxing systems.

II - 2.1 Contrasting the GST with the PST Systems

In many respects, the federal and provincial systems are like night and day. If generalizations can be drawn between the two, there are two fundamental differences.

II - 2.1(a) Differing Tax Bases

The most obvious is the differing tax bases. While the GST is an all-encompassing tax, the provincial sales tax systems are generally aimed at comparatively narrow tax bases. For example, the GST is levied on virtually all tangible personal property ("TPP", or "goods"), intangible personal property ("IPP"), real property, and services.

On the other hand, the various PST systems are usually aimed at levying tax on transactions involving only goods, and certain specially defined "taxable services". Having said that, these provinces generally employ an all encompassing definition of TPP[46] which is capable of capturing virtually all goods, as well

[46] Under section 1 of the Ontario *Retail Sales Tax Act*, for example, TPP is defined to be "personal property that can be seen, weighed, measured, felt or touched or that is in any way perceptible to the senses and includes computer programs, natural gas and manufactured gas".

as what might otherwise be considered as IPP and/or services. For example, all provinces now attempt to tax computer software – see *infra*.

In terms of the specially defined "taxable services", most provinces attempt to tax services related to goods (e.g., like services to install, assemble, dismantle, repair, adjust, restore, recondition, refinish, or maintain TPP), as well as certain other special-nature services.[47] More recently, some provinces have been adding to their definition of "taxable services", so as to parallel the broad tax base now in place under the GST/HST.[48]

II - 2.1(b) Focus of the Tax & Treatment of Inputs

A second fundamental difference between the GST and the various PST systems lies in the overall focus of the tax, and the consequent treatment of business "inputs". While the GST is a multi-stage value-added tax, with a comprehensive system for taxing the value-added at each stage of the production process, and crediting tax paid at the earlier stages of that process (e.g., through ITCs), the PST systems are aimed at (theoretically) imposing the PST only on the ultimate consumer or user of the taxable good or service. In other words, these systems attempt to create a "single incidence" tax.

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47 For example, Ontario currently defines the following services to be "taxable services":

(a) telecommunication services of all kinds, including without restricting the generality of the foregoing, telephone and telegraph services, community antenna television and cable television, transmissions by microwave relay stations or by satellite, and pay television, but not including public broadcasting services that are broadcast through the air for direct reception by the public without charge,

(b) transient accommodation,

(c) labour provided to install, assemble, dismantle, adjust, repair or maintain tangible personal property,

(d) any contract for the service, maintenance or warranty of tangible personal property; or

(e) the provision of the right to park a motor vehicle or to have a motor vehicle parked in a commercial parking space.

Bill 198 also proposes to include the "service, maintenance or warranty of a computer program, as those expressions are defined by the Minister" in "taxable service" definition. With the exception of transient accommodation, which is taxed at a special rate of 5%, each of the "taxable services" above is taxed at the normal Ontario PST rate of 8%.

48 A good example of that can be seen in Saskatchewan's 2000 budget which served notice that a variety of services will soon be fully taxable in Saskatchewan, including virtually all professional services (e.g., legal, accounting, architectural, consulting, and engineering), placement services, and computer services. See for example, the Saskatchewan Information Bulletin entitled *Summary Of Changes To E&H Announced In March 29, 2000 Budget* (March 29, 2000). As indicated above, Ontario is currently in the process of enacting legislation so as to specifically include computer related services in the definition of "taxable service".

Figure 4: ***Example – Cascading of Provincial PST***

Consider Kco, an Ontario woodworking business, which builds and sells custom-made children's beds – called the "Prince William Bed". Ten beds are produced each year and sold for $1000 each, ultimately yielding $800 in Ontario PST (8% times $10,000).

To manufacture the beds, Kco purchases a number of raw materials, which can be purchased exempt of Ontario PST, as well as a taxable desk and computer for $5,000, paying an additional $400 in Ontario PST on these inputs.

Assuming that the PST paid on the inputs is reflected in the final selling price of the beds, the effective rate of Ontario PST on the beds is much higher than 8%, perhaps approaching 12% in this simplistic example.

One effect of this "cascading" of tax is to make Kco susceptible to competition from manufactures in other jurisdictions (e.g., the Harmonized Provinces) who might be entitled to ITCs for the PST paid on their business inputs, enabling them to sell their beds at a cheaper price.

This poses a problem for business inputs, since situations arise where a business may be paying the PST on its business inputs, and then charging and collecting the PST again on the value of its production or output. Absent rules to "remove" this cascading of tax, the final manufactured product may well bear double and triple layers of tax. While each PST system has some rudimentary rules providing for some limited exemptions (e.g., an exemption where goods are purchased for "resale"), these rules are nothing like the "universal" ITC system available for commercial businesses paying the GST. Thus while the GST system ensures that every good, service or intangible consumed in Canada bears, at the most, a 7% GST component, the effective rate of PST imposed on fully manufactured Canadian goods may be much higher than the stated provincial rate. (See Figure 4).

Even more troubling, to the extent there is PST imbedded in manufactured goods, those goods will carry that PST even when they are exported from Canada.