New Canadian Sales Tax Policy to Put the Big Bite on U.S. Lessors

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Introduction

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" lessors with Canadian lease 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 "Revised Policy"). CRA is requesting comments on the Revised Policy so if this policy will have any effect on your business please read further.

Document

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The Revised Policy will have big consequences for U.S. and other foreign lessors, and is expected to attempt to force these lessors into the GST system wherever their operations have any connection at all to Canada.

The balance of this note outlines the framework in which these GST rules arise, and discusses the way in which the Revised Policy is expected to impact non-resident lessors.

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 and most services and other

intangibles. Thus a lessor leasing equipment in Canada would generally be required to register for the GST, and to begin charging and collecting the GST from its lessee customers, and then remitting GST to the Canadian government. In some instances, an additional 8% HST (Harmonized Sales Tax in New Brunswick, Nova Scotia and Newfoundland) 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.

The Revised Policy now seeks to change all of that and, in our view, will force any non-residents engaged in any leasing operations in Canada to both register for the GST, and begin charging, collecting and remitting GST.

Figure 1: ***Example – Basic Leasing Situation***

EXAMPLE 1 - LEASE OF TANGIBLE PERSONAL PROPERTY

Facts

1. A non-resident person that has a leasing business outside Canada enters into a sale-leaseback agreement to purchase a conveyance and supply it by way of lease to a resident registrant who will use the conveyance in Canada.
2. Pursuant to the agreement, delivery of the conveyance sold to the non-resident occurs in Canada.
3. The lessee has physical possession of the conveyance when the agreement is concluded.
4. The agreement is concluded outside Canada.
5. The conveyance is to be maintained by the lessee at its own expense.
6. The non-resident has no employees in Canada.
7. Payments are made to the non-resident outside Canada.
8. The non-resident does not have a bank account in Canada and is not listed in a directory in Canada.
9. The non-resident does not solicit orders in Canada.

Decision

The non-resident lessor is carrying on business in Canada.

Rationale

For GST/HST purposes, a "business" includes any activity engaged in on a regular or continuous basis that involves the supply of property by way of lease. The non-resident lessor is considered to be in the business of supplying tangible personal property by way of lease. For GST/HST purposes, the supply of property under a lease is considered to be made on a regular and continuous basis. The non-resident lessor is considered to have made a separate supply of the property for each period to which a lease payment is attributable13. Also, a supply by way of lease, licence or similar arrangement of the use or the right to use tangible personal property is deemed to be a supply of the tangible personal property. The "profit making apparatus" for GST/HST purposes is considered to be the tangible personal property being leased.

In this case, both delivery of the conveyance to the lessor and the lessee under the agreement occur in Canada and the conveyance (i.e. the "profit making apparatus") is based in Canada during the term of the lease. These facts combined with the application of the GST/HST provisions indicate that the non-resident lessor is carrying on business in Canada.

What the Revised Policy Says

In a nut shell, the Revised Policy creates a "nexus" test for

determining when a non-resident will be seen to be carrying on business in Canada. For non-resident lessors, the "nexus" threshold is set extremely low, as the following two examples demonstrate.

Delivery of Equipment in Canada REQUIRES GST REGISTRATION

A careful review of the Revised Policy indicates that in virtually any case where a non-resident lessor delivers equipment under a lease arrangement to a lessee in Canada, the lessor will be regarded as carrying on business in Canada, required to register for the GST, and required to charge and collect GST on each lease payment.

This result will seem to follow even if the non-resident did not solicit the lease transaction in Canada, ensures that the lease agreement is concluded outside Canada, and ensures that it never maintains any Canadian employees or bank accounts, and always requires all payments under the lease to be made outside Canada.

Figure 1 is an excerpt of the relevant example.

Taking Assignment of Canadian Lease REQUIRES GST REGISTRATION

In another startling position, the Revised Policy indicates that even where there is a mere assignment of an existing Canadian lease to a non-resident lessor, the lessor will again be regarded as carrying on business in Canada and required to register for the GST, and begin complying with its collection and remittance obligations.

This result will again follow even if

Figure 2: ***Example – Taking Assignment of Canadian Lease***

EXAMPLE 4 - ASSIGNMENT OF LEASE

Facts

1. A resident registrant (the "original lessor") who is in the business of leasing tangible personal property outside Canada enters into a lease to supply by way of lease a piece of industrial equipment to another resident registrant (the "lessee") who will use the equipment at its business facilities in Canada.
2. Pursuant to the lease, possession of the equipment is given to the lessee in Canada.
3. The original lessor subsequently enters into an agreement (the "agreement") to sell, assign, and transfer all rights, title, and interest in the lease and the equipment to a non-registered non-resident person, resulting in that non-resident becoming the new lessor of the equipment.
4. Pursuant to the agreement, delivery of the equipment sold to the non-resident occurs in Canada.
5. The lessee has physical possession of the equipment in Canada when the agreement is concluded.
6. The agreement is concluded outside Canada.
7. Pursuant to the terms of the lease with the original lessor, the equipment is to be maintained by the lessee at its own expense.
8. The non-resident has no employees in Canada.
9. The lease payments are made to the original lessor in Canada on behalf of the non-resident. The original lessor forwards the lease payments to the non-resident.
10. The non-resident does not have a bank account in Canada and is not listed in a directory in Canada.
11. The non-resident does not solicit orders in Canada.

Decision

The non-resident is carrying on business in Canada.

Rationale

In this case, the non-resident is acquiring the equipment in Canada and the lessee has acquired possession of the equipment in Canada and the equipment (i.e. the "profit making apparatus") is also located in Canada during the term of the lease. The lease payments are also made in Canada. These facts combined with the application of the GST/HST provisions that relate to the supply of property by way of lease indicate that the non-resident lessor is carrying on business in

the non-resident did not solicit the assignment transaction in Canada, ensures that the assignment agreement is concluded outside Canada, and ensures that it never assumes physical possession of the good, never maintains any Canadian employees or bank accounts, and always requires payments to be made outside Canada.

Figure 2 is an excerpt of the relevant example.

Implications

Many U.S. and other foreign lessors often engage in the odd "Canadian" lease transaction. The current Revised Policy appears aimed at making the costs of engaging in these isolated transactions prohibitive, and this new policy will likely be a shock to most of these lessors.

U.S. lessors and other foreign lessors who now find themselves caught by the new rules ought to consider obtaining the planning advice they need in order to stay on-side the new rules, or minimize the application of the GST to their business activities.

Lessors who fail to react risk the CRA imposing penalties for non-compliance, and taking other enforcement action (e.g., seizure) against their Canadian-based equipment.

You can find the Revised CRA Policy on the Web at:

http://www.cra-arc.gc.ca/E/pub/gi/notice194/notice194-e.html

We encourage U.S. and foreign lessors to comment .