Five Commodity Tax Traps

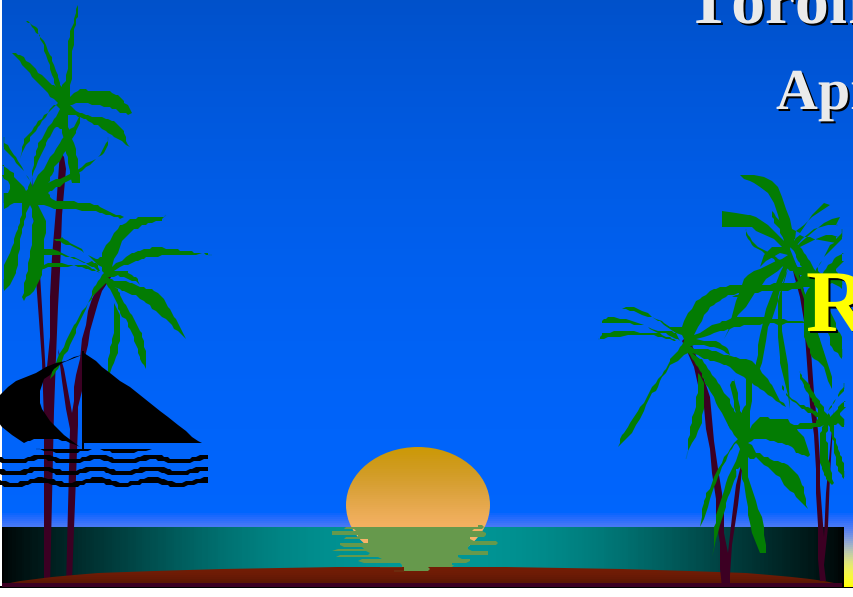
INCOME TAX PRACTITIONERS WILL WANT TO KNOW ABOUT

MILLAR
WYSLOBICKY
KREKLEWETZ

A Presentation at a Lunch Meeting
of the CBAO's Tax Section

Toronto, Ontario
April 4, 2000

ROBERT G. KREKLEWETZ



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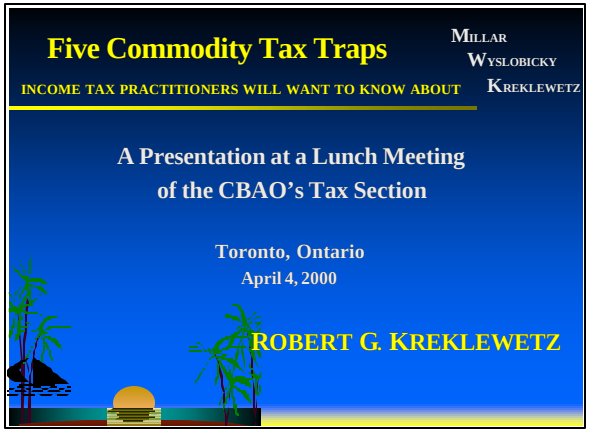

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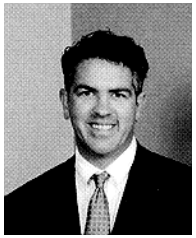
PROFESSIONAL PROFILE



ROBERT G. KREKLEWETZ, LL.B., M.B.A.

Rob is a partner at Millar Wyslobicky Kreklewetz (MWK) – a boutique tax law firm specializing in all **Commodity Tax, Customs & Trade** matters**,** and in **Tax Litigation**. Rob has a LL.B. from Osgoode Hall Law School, and a M.B.A. from York University.

Specialized Practice Area

Rob's practice area focuses on **Commodity Taxes**, which includes *value-added taxes* like Canada's federal *GST* as well as Quebec's *QST*, and the Atlantic Provinces' *HST*. Rob's focus on Commodity Taxes also includes the application of the *Provincial Sales Taxes* in Ontario, BC, MB and SK, as well as the application of various other federal and provincial *Excise Taxes and Duties*, applying to things like tobacco, alcohol and motive fuels. Equally, Rob's practice area also focuses **Customs & Trade** matters, including *Customs Valuation*, *Tariff Classification*, *Rules of Origin*, *Marking*, *Ascertained Forfeitures*, *Seizures*, and other *NAFTA* or *WTO* issues. Finally, Rob's practice area includes all other **Tax-Related Matters** involving the international movement of goods, services and labour, including *Transfer Pricing* issues, Ontario *Employer Health Tax* matters, tax issues involving the establishment of a Canadian business, and any and all tax and competition law issues affecting the Canadian Direct Selling Industry.

Extensive Tax Litigation Experience

All elements of Rob's practice include **Tax Litigation**, and Rob has acted as lead counsel in a significant number of cases before the Tax Court of Canada, Canadian International Trade Tribunal, Federal Court (Trial Division), Federal Court of Appeal, Ontario Court of Justice, and Ontario Court of Appeal.

Speaking Engagements. / Memberships

Rob has written and spoken extensively on all of these areas, and in a number of different venues. Most notable are his regular speaking engagements at the Tax Executive Institute (TEI) – both at its Annual Conference and various Chapter Meetings – and his regular speaking engagements at Annual Conferences held by, among others, the Canadian Tax Foundation, Canadian Bar Association (CBA), Canadian Institute of Chartered Accountants (CICA), Canadian Finance and Leasing Association (CFLA), Canadian Importers Association, Canadian Association of Certified General Accountants, and the Canadian Direct Selling Association (DSA). He also speaks frequently at Strategy Institute, Infonex, and CCH Tax Conferences.

Rob is the regular commodity tax contributor to the Tax Foundation's *Tax Highlights* publication, and a regular contributor to a number of other tax publications, including the *Sales and Commodity Tax Journal*.

Rob is a member of the CBA (Ontario)'s Tax Executive Committee, the CFLA's Tax Committee, and the DSA's Government Affairs Committee. Rob was a member of the CBA-CICA working group on the 1993 GST amendments, and consulted with the Department of Finance on the more recent HST.

The Real Important Stuff

Rob is married to Franceen, and has a beautiful 2 year-old son named William. When he is not working, he enjoys spending as much time with them as he can – with only the exception being the odd round of golf.

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ROAD MAP

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1. Anything to Do with Leasing
2. Ontario & The Wild Wild West
3. Closely Related Asset Transfers
4. E-Comm & Near-E-Comm
5. Dealings with Non-Residents

Slide 4

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Roadmap

We will spend approximately 3 to 5 minutes of each of five common commodity tax traps that Income Tax practitioners might want to know about.

Questions at any point in the presentation are welcomed.

Reference to the good and services tax ("GST") legislation will be to Part IX of the *Excise Tax Act* (the "*ETA*"), including relevant schedules.

Reference to the Ontario provincial retail sales tax ("RST") will be to the Ontario *Retail Sales Tax Act* (the "*RSTA*").

1. Anything to Do with Leasing

Leasing presents a difficult area for purposes of Commodity Taxation. The reason may well be that commodity taxes, by their very nature, usually apply on a one-time basis, applying to a particular supply, in a particular place, at a particular time. Leasing involves a continuing supply of essentially the same good, invoking a time element that is not otherwise present in other supplies. And there's the rub.

There are a number of current commodity tax issues involving leasing transactions, with a few described below.

Ontario: Status of Lease Damages Payments. Many attendees will be aware of the *Extendicare* case, which first brought into question whether the payments made by a lessee on the breach or termination of a lease were subject to Ontario's RST.

Ontario has long been of the view that virtually all payments made on the termination or breach of a lease were subject to Ontario RST, which has historically required lessors to charge additional Ontario RST on these payments to defaulting lessees. This position was based on Ontario's long-standing position that the tax status of a lease – any virtually any payment made under (or related to) that lease – was crystallized at the inception of the lease.

The *Extendicare* case saw one such lessee challenge that position, and assert that payments made on the breach of a lease were not subject to RST.

While losing the initial round of courts appeals, the lessee in *Extendicare* recently managed to convince Ontario's highest court that its position was correct, and that Ontario RST should not apply to lease damages payments.

In making its ruling, the Court of Appeal first focused on characterizing the payments in question. Unlike the lower Court's decision, which appeared to have concluded that the payments made under the liquidated damages were merely "lease termination" payments, the Court of Appeal clarified that the liquidated damages clause in the Extendicare lease permitted a lessor, faced with a breach of a lease by the lessee, to recover "as damages" certain amounts that would have been payable had the lease not been breached. That was an important conclusion, since it allowed the Court to dismiss the Crown's submission that Extendicare's obligation to pay rent did not end with its breach of the lease – the Crown arguing that the two post-breach payments in question "could reasonably be considered rental payments under the lease agreement".

Instead, the Court of Appeal relied on Supreme Court jurisprudence in the leasing area to conclude that once the contract was repudiated, it was effectively at an end, and concluded that any monies paid after the repudiation were in effect, payments made to forestall the legal action that could have arisen because of the breach of the lease. In the Court's view, "the post-breach negotiations, and the two payments made as a result of those negotiations, took place under the umbrella of a potential lawsuit for damages for breach of contract", and were not merely "rent" paid under the original lease.

The next question for the Court was whether the damages payments were subject to tax under the Ontario *RSTA*. Concluding that the relevant charging provision was section 2(1), the Court indicated that the damages payments were not caught, for a number of reasons, some of which are as follows:

(1) The payments appeared unrelated to any "consumption or use" of tangible personal property ("TPP"), which was a requirement in section 2(1). The Court indicated that since the equipment was repossessed once the lease was terminated, there "could be no further consumption or use".

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(2) The payments did not appear to have been made for TPP – another requirement in section 2(1). The Court indicated, instead, that the payments were really made "to purchase [the lessor's] acceptance of Extendicare's breach and reputation of the lease and to 'buy off' a potential damages award that [the lessor] might obtain in a lawsuit" – and in that sense, the purchase of "intangibles".

(3) The Court observed that the lease payments did not fit very well with the concept of "rent" in current section 2(7) of the Act, an indication that section 2(1) was not meant to catch the payments in the first place.

(4) The legislative history surrounding section 2(7) seemed to indicate an intention in the Act to "make a link between the tax payable and the use made of the property by the lessee", again leading to the conclusion that the payments in question were never intended to be caught by section 2(1).

Commentary. At the hearing, the Court seemed focused on drawing a "bright line" test for determining when RST on leases would end. It clearly appeared that the Court was of the view that while the lease was in operation, and rent was being paid, RST would apply. On the other hand, it was equally clear that the Court took the view that where litigation ensued, and damages were awarded to the successful lessor, no RST would apply on those amounts.[1]

Having determined that a bright line test was necessary, the Court's decision was perhaps not unexpected. As it is, the Court's decision probably goes further than simply applying to negotiated damages payments. Near the end of its judgment, the Court indicated that the "consumption and use of the computer equipment stopped and payments on the lease ceased", and that the resultant damages payments achieved two purposes, (1) they purchased Canada Lease's acceptance of Extendicare's repudiation of the lease (thereby terminating the contract), and they purchased Canada Lease's forbearance from commencing a lawsuit in which, potentially, Canada Lease could have recovered about double the settlement payment amounts. In the Court's view, the "two payments were made in the context of a termination of all relationships (contractual and litigation) between the parties, not in the context of a continuing lease", and accordingly, did not come within "the whole scheme of the Act".

There is no word yet on whether the Crown will be seeking leave to the Supreme Court of Canada, although the dead-line for the application is April 8, 2000.

Ontario - Lease Termination Payments. One would have thought that a logical extension of the Extendicare decision was that even mutually negotiated termination payments, aimed at terminating an existing lease, but this time without the threat of litigation, ought to also escape RST. Certainly, all the reasons in the Court's judgment would seem to apply to these sorts of payments – even though the decision may not technically address that fact pattern.

Presently, however, Ontario still remains of the view that payments made on the termination of a lease are subject to Ontario RST.[2]

Ontario - Lease Buy-outs for Resale Purposes. Perhaps as a corollary of its position that the tax status of all leases is crystallized at the time a lease is entered into, Ontario has also adopted the position that when it comes time for the exercise of a lease option, RST is exigible in virtually all instances.

In particular, Ontario has been unwilling to accept purchase exemption certificates ("PECs") from lessees intending to purchase the leased assets for resale purposes – which has always been a manner (for constitutional reasons) in which goods may be purchased without RST.

Again, one would have thought that a logical extension of Extendicare is that in instances such as these, where there is no "use" or "consumption" intended by the lessee, no RST ought to apply.[3] Presently, however, Ontario still remains of the view that the exercise of a purchase option in these instances is normally subject to RST.[4]

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1. While the Court obtained a concession from Crown counsel on this point, it was entirely clear that such a concession was expected, and barring such a concession, the Court would have concluded the same in any event.

2. Note that for GST purposes, a special rule applies for payments made on the breach, modification or termination of a lease, found in section 182 of the *ETA*. Note, however, CCRA Policy P-218, *Tax Status of Damage Payments Not Within Section 182* …, which sets out a number of damages payment that the CCRA considers (for some reason) outside the literal scope of section 182.

3. Here the "use" or "consumption" will occur with the subsequent purchase, which will presumably be subject to RST based on the amount paid by the subsequent purchaser.

4. There may be limited exceptions to this administrative policy, but only in instances where the purchase is being made by a lessee who was leasing the property on an exempt basis in the first place (e.g., a lessee leasing for the purpose of sub-leasing to a sub-lessor).

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GST - Lease Interval Rules Under the HST and GST. Many attendees will be aware of the addition of so-called "place of supply" rules under the HST system. These place of supply rules are designed to ensure that as goods or services are supplied across Canada's provinces, an appropriate set of rules are in place to determine when and where the GST applies, and when and where the HST applies.

For HST purposes, a decision was made to consider each lease of goods to be a number of separate supplies, each occurring (generally) at the time the lease payment is made. (The lease interval rule is found in section 136.1 of the ETA). That means that while a lease might be supplied "in Ontario" in the first month of its existence, it could well be deemed to be supplied in an HST province in subsequent months. Under the HST Place of Supply Rules, which are found in section 2 of Part II of Schedule IX of the ETA, one normally looks to the "the ordinary location of the property" at the time the supply (i.e., at the time of the lease payment).[1]

Note, however, that the general GST place of supply rules supercede the HST rules. That means that even if the "ordinary location" of a particular asset is in a particular province, there may be no GST (or HST) due at all. Such would be the case, for example, where the asset was supplied by way of lease "outside Canada" in the first place. In that instance, no GST (of HST) would ever apply on the lease payments – although GST/HST would have normally been exigible on the importation of the asset under Division III of the ETA – payable on the "duty paid value" of the entire asset.

GST - Finance vs. Operating Leases. Unlike the very well-known situation for Income Tax purposes (as set out in IT-233R, *Lease-Option Agreements; Sale-Leaseback Agreements*), for purposes of applying the GST leasing rules, the CCRA does not differentiate between "finance" and "operating" leases. For GST purposes, the CCRA adopts a policy that "a lease-is-a-lease-is-a-lease".

While the apparently asymmetrical approach might be viewed with a good bit of incredulity, it is an obvious necessity given the scheme of the *ETA* as a whole, and the manner in which the CCRA has seen fit to administer the GST in the context of the asset-based financing industry.

2. *Ontario and the Wild Wild West*

Like it or not in Ontario, very few RST cases get to Court. When coupled with the *RSTA* – which can at best be described as a "hodge-podge" of legislation – the inevitable result is an Act that is administered more by way of administrative fiat than legislative mandate. Adding to the problems that one generally sees when bureaucrats get involved is an overly aggressive stand being taken by the Ontario Ministry of Finance ("MOF"), which audits likes its in the Wild Wild West – shooting first and asking questions later – and administers policy on the same basis as well.

There are numerous examples of that, some of which are as follows.

Audit Policy – Shooting First, Asking Questions Later. Despite cases like the recent decision of Judge Bowman in *897366 Ontario Limited* (the "*Carlile*" case) – where the Tax Court of Canada levied the hammer on the CCRA's use of the 25% GST penalty in cases where the *mens rea* component of the civil offence was obviously missing – the Ontario MOF continues to shoot first and ask questions later. Assessments are fearlessly raised, even in the face of legitimate representations. Penalties are assessed even in the absence of *mens rea*. And criminal action is used more as a civil deterrent than to really address criminal situations.

> *Example.* In our experience, virtually every situation which involved the 25% penalty at the audit stage, is usually coupled with a referral to Special Investigations on the criminal side – often turning what one would have thought to be a straightforward case of civil non-compliance into a whole other matter.

Ontario's aggressive positioning can be seen in its approach to more substantive issues as well. [1]

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1. There are exceptions for short-term rental situations (i.e., no more than three months) and in the case of motor vehicles.

2. Apart from the examples below, Ontario approach to the application of RST to leases (and in particular, lease buy-outs intended for resale) is an excellent example of the aggressive positioning which is being referred to.

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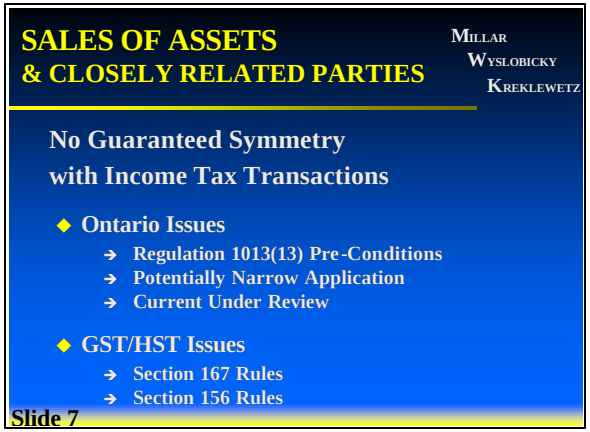

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Fixtures & Real Property Contacts. As many attendees will know, the general rule in RST systems is that "fixtures" – and other "real property" – are not subject to RST. A real property contract, in this sense, involves a supply by a person of TPP, which will eventually be installed by the person in "real property", and thereafter form part of the "real property".

> *Example.* An example of this might be a kitchen cabinet manufacturer who agrees to supply and install kitchen cabinets. Since the cabinets will become attached to real property, they would generally be considered to be the supply of a "fixture".[1] Other examples might include contracts to, say, install seats in sports arenas, elevators in buildings, storage tanks in factories, etc.

Where TPP becomes attached to "real property" – and somewhat like the manufacturing process where TPP inputs lose their identity as separate items of TPP when the "new good" is created – it loses its identity as TPP. Accordingly, what the purchaser actually acquires is non-taxable "real property", not taxable TPP.

Accordingly, under all RST systems, purchasers of real property or fixtures do not generally pay RST. There is, however, an added complication. Under jurisprudence first developed in the *Cairns Construction* case,[2] the "consumer" or "user" of the TPP involved in a real property contract is the last person using it: in this case, the real property contractor. Accordingly, all RST systems have rules aimed at ensuring that such real property contractors self-assess and remit tax on the cost of the TPP they use.

With this back-drop in mind, Ontario has traditionally taken a very very narrow (and aggressive) view on what amounts to "fixture". Consequently, things that one would have thought were clearly fixtures under the common law jurisprudence, are not currently being considered to be fixtures by the Ontario MOF. Perhaps somewhat problematic, at least on the fixtures front, is recent Ontario jurisprudence, like that in the *Ontario Hydro* case, which may suggest that Ontario's position is correct.

The Scope of Telecommunications Services. In Ontario one also sees the MOF taking a fairly aggressing view of what amounts to a "taxable" telecommunication service. Telecommunications services are of course taxable for Ontario RST purposes, and for purposes of the sales and use taxes in every other Canadian jurisdiction, including the GST/HST.

Recently, Ontario has been more prone than not to considering things like networking and intranet services to be part of taxable telecommunications services – although there administrative treatment has not been that consistent.

Example. In the easy example, a company might offer limited storage of data, but access to an intra-net service, through their "server", while also arranging the telephone lines necessary to link their server to their customer's own computer system, such that the relevant digitalized information can be transmitted back-and-forth. If one fee is being charged, the interesting question arises as to just what is being provided, and how that should be treated for RST purposes. On one side of the fence, Ontario might take the view that what is being provided is a taxable telecommunications service, and that the supplier is required to charge and collect RST on the whole bundled fee. On the other side of the fence, one might suggest that what is being provided is a completely new and "non-taxable" service.

Variation on the Example. A variation on the example will show the difficulty. If as a lawyer, I use telecommunications facilities to receive information (e.g., a telephone call to discuss background facts, followed-up by a fax of relevant documentation), then spin the information around in my head, and then use telecommunications facilities to send some information (e.g., a telephone call to discuss my views, followed-up by a faxed letter), would anyone suggest that I have provided "taxable telecommunications" services – even if, say, I arranged from Bell Canada to bill on my behalf. The answer is undoubtedly "no", but the reason lies in the implicit characterization analysis that must occur – and the ultimate realization that what I am getting paid for is, predominantly, my legal advice. (And at least in Ontario, legal services are that is still a non-taxable.)

To date, it is probably open to assert that Ontario is improperly blurring the line of demarcation between telecommunications services and, say, networking or intra-net services.

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1. The word fixture means something which so attached to land as to form in law part of the land. See *The Law of Real Property*, (3rd), Megarry and Wade (London: Stevens & Sons Limited, 1966) at page 715. See also the leading case of *Stack v. T. Eaton Co. Ltd.*, (1902) 4 O.L.R. 335 (Div. Ct.). These concepts were most recently applied in *Ontario Hydro v. Minister of Revenue*, [1996] 5008 ETC (Ontario Court of Justice); subsequently appealed and upheld by the Ontario Court of Appeal, [1999] 5019 ETC (ONCA).

2. See *Cairns Construction Ltd. v. Gov't of Saskatchewan*, [1960] S.C.R. 619.

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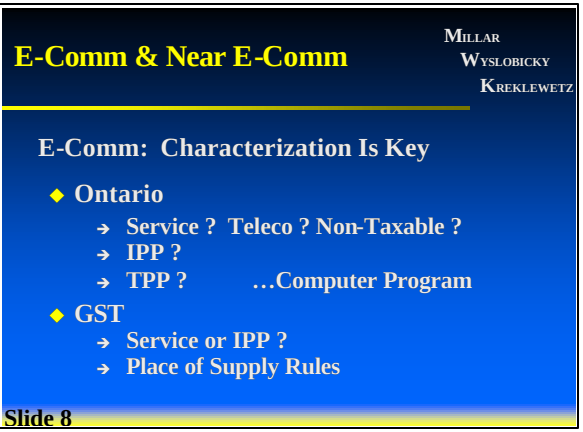

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3. Related Parties & Asset Transfers

Income tax practitioners often incorrectly assume that there is complete symmetry between rollover provisions in the *Income Tax Act* (e.g., s. 85) and similar provisions in the *ETA* or the *RSTA*. Such is not the case.

Ontario Trap. The *RSTA* contains a set of rollover provisions, found buried in section 13 of Regulation 1013, but the application of those provisions to any particular set of facts is usually difficult to determine. First, the application of the provisions is 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 TPP that is being sought to be transferred on a non-taxable basis – in other words, once Regulation 1013(13) has been used, it cannot be used in respect of the same TPP again; 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. Those are pretty daunting pre-conditions, and usually leave nothing but uncertainty in anyone's mind. The practical result is that there are very few situations are are "slam dunk" rollover situations – at least when it comes to the PST side of things.

Even where these pre-conditions can be reasonably regarded as having been met, Ontario has been known to take a fairly narrow view on the application of the Regulation 1013(13) rules.

Effectively, the entire section ought to be read each time resort to the rules is needed.

Some potential traps are as follows: (1) Ontario requires 95% control for the appropriate relatedness to exist (the companies are then said to be "wholly owned"); (2) where two companies are "wholly owned", Ontario allows asset transfers from one to the other, or indirectly from one to another through a third "wholly owned" company, but in no other way.

Example. A "wholly owns" B. In turn, B wholly owns C, and C wholly owns D. Assuming all other pre-conditions are met, Ontario would allow A, B, and C to buy from or sell to each other on a non-taxable basis under Regulation 1013(13). However, in no circumstances would A or D be able to buy from or sell to each other on a non-taxable basis.[1]

The Regulation 1013(13) rules are currently under review in light of some announcements in the May 1998 Ontario Budget, and some changes are expected. My understanding is that part of the delay in this process has arisen because of an intent by Ontario (finally) to review the policy intentions underlying the Regulation 1013(13) rules, and attempt to consider whether it is advisable to expand their application to provide greater symmetry with common income tax rollovers.

GST Traps. On the GST side, one often sees problems in the application of basic sections like the section 167 election, and the section 156 election.

With respect to section 167 elections, which are intended to provide for the non-taxable transfer of a business, in certain instances, it is important to note that it will *not always* apply whenever a "business" or any "part" of a business is being sold. Rather, specific rules must be met. For instance, it must be demonstrated that the purchaser is acquiring "ownership, possession or use of all or substantially all of the property that can reasonably be regarded as being necessary for the recipient to be capable of carrying on the business or part as a business".

Also a trap for the wary is the fact that even if section 167 applies, certain supplies from the vendor to the purchaser of a business will still attract GST. For example, (i) "services" that will be rendered by the vendor in the future will still be subject to GST; (ii) leases or licences of real property will still be subject to GST; and (iii) sales of real property will sometimes be subject to GST (if the purchaser is not a "registrant").

Additional Note: Remember that in formulating section 156 elections for Specified Members of Closely Related Groups, that the election is not available for Non-Resident members.

1. For example, Ontario would not allow A, B, and C to "plan around" the problem by having B purchase from A "for resale" – paying no RST – and then selling to D under the Regulation 1013(13) rules.

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4. E-Commerce & Near E-Commerce

Characterizing E-Commerce Transactions. Probably the most difficult problem currently being posed by e-commerce for Commodity Tax practitioners is determining the "character" of particular e-commerce transactions (e.g., provision of service, intangible, etc.).

Ontario. On the Ontario RST side, there are a number of relevant questions: is the supply a service or an intangible ? If a "service" is being supplied, it is a "taxable service", a taxable "telecommunication service", or (by definition) a non-taxable service. If intangible personal property ("IPP") is being provided, it would usually be non-taxable, unless somehow falling within the *RSTA's* new deeming rules for "computer programs".

Accordingly, characterization can be very important, and ultimately determine whether or not a transaction is taxable for Ontario RST.

The difficulties in this area are illustrated by the "telecommunications services" vs. "networking" discussion above.

GST. On the GST side, the characterization is a bit less important (i.e., since *everything* is taxed for GST purposes, irrespective of its status as a good, service, or an intangible). While a *bit less important*, characterization is not altogether irrelevant. The reason lies in the application of the GST and GST/HST Place of Supply rules, which are triggered by the nature of the supply. Thus, in order to determine whether a particular supply is "made in Canada" or "made in a particular province", one needs to be able to characterize a supply.

For example, what is the proper character of a supply of allowing a person access to a proprietary database of information, through the internet, and perhaps containing a number of intellectually protected source items ? What if the source items are not available anywhere else ? Clearly the supply is not the supply of a good, but whether or not the supply amounts to a "service" or the "provision of IPP" makes a difference in determining these place of supply rules.

Example. Consider the Database scenario above. If the supply is characterized as a provision of IPP (e.g., a license to use), the relevant GST/HST Place of Supply rules are found in Part III of Schedule IX of the ETA, which speak to a number of possible treatments, and even address situations where the IPP "relates to services to be performed".

On the other hand, if the supply is characterized as a "service", the relevant GST/HST Place of Supply rules might be found in Part III of Schedule IX of the ETA, or perhaps in special Regulations, called the Place of Supply (GST/HST) Regulations, currently in draft form. Section 10 of those Regulations provides a special rule for services "involving the electronic storage of information and computer-to-computer transfer of information".

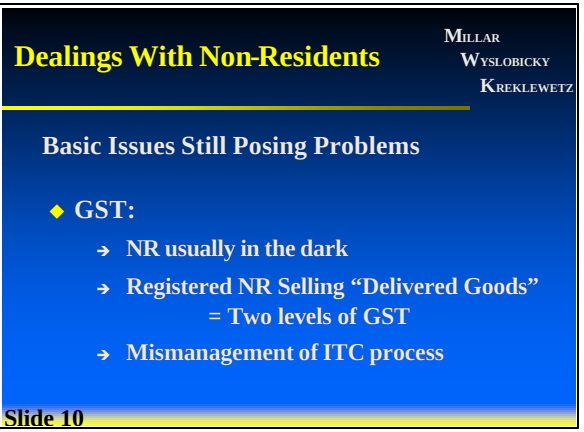
Accordingly, characterization can be an integral concept for GST purposes as well.

Computer Software & Taxable Services. Much to the dismay of Ontario's computer consulting industry, a relatively unpublicized effect of the recent "tangibilization" of "computer programs" is the treatment of related taxable services.[1]

To understand the problem one has to make an association. The association is that once something is TPP under the Act, virtually anything – and I am may be over-generalizing a bit here –that one does to that TPP, for a price, may also be subject to RST. The most basic way this occurs is under the Act's definition of "taxable service", which defines a "taxable service" as, among other things, any "labour provided to install, assemble, dismantle, adjust, repair or maintain" TPP.

What this has meant in practice is that once "software" became TPP – which is how the May 1997 rules went about taxing it – virtually anything done to it became taxable as well. Compounding the problem, was that prior to the May 1997 changes, Ontario's rules regarding the tax status of similar consulting services were less than clear, and less than consistently applied. Whatever the previous lack of clarity, the tax status of computer consulting services is now becoming crystal clear to most of Ontario's computer

1. Ontario changed its legislation – effective with its Budget announcement in May 1997 – to legislatively confirm its administrative approach of taxing computer software on the basis that it amounted to a "good". The effect of the rules is now to deem virtually any computer program to be TPP, and taxable when sold. Limited exemptions exist for certain narrowly defined transactions, such as the creation of "custom" software.



MILLAR WYSLOBICKY KREKLEWETZ

consulting businesses, which are now finding that the bulk of their services are subject to RST. The practical result, for many, is an additional 8% cost, applied to their gross revenues over the last 4 years – plus interest. Not a very pretty picture.

Not only is that a surprise to most persons, but there are also some difficult issues that arise where the taxable services are bundled with either non-taxable services (e.g., pure training, pure consulting) or exempt services (e.g., services related to exempt custom software).

5. *Dealings With Non-Residents*

A continuing area of difficulty is the application of the GST is in the area of non-resident ("NR") transactions. There continue to be a number of difficult issues persisting, and perhaps even more surprising, even the "simple" issues are presenting difficulties to NRs.

The problem likely lies in the fact that few NRs have taken the time (or had the inclination) to determine how Canada's value-added taxing system (i.e., the GST) really works, or paid for Canadian advice on the subject. The result is a real hodge-podge of approaches being taken, including a self-help favourite: registering for the GST.

For NRs, GST registration can present a tricky thing for the unwary tax advisor, as even finding out the GST status of a NR person is sometimes difficult – and depends on just who is in the "know" in the particular organization. Moreover, one registered, the NR has positive collection obligations, and must begin charging and collecting the GST on most supplies made into Canada – particularly where meeting the "made in Canada" rules under the section 142 Place of Supply Rules.[1]

This obligation is to charge and collect GST from Canadian recipients – under Division II of the *ETA* – and remit that GST to the Canadian government, netting out possible ITCs.

Where the NR sells goods into Canada, which would usually also be subject to GST at the Canadian border – under Division III of the *ETA* – many NRs get confused as the the status of the transactions, with some even pocketing the tax collected from the Canadian recipient, believing it to be the manner in which the GST paid at the border is to be "recovered".

And for any attendees thinking that "my client" is probably a NR with too much sophistication to mess up on the easy stuff, the *Toyota Tsusho* case[2] is an excellent example of how even big-time NRs can find themselves in non-compliance situations.

> *Example.* In *Toyota Tsusho*, the Court considered a registered NR, and whether penalties ought to be levied for GST non-compliance in a cross-border situation. On the facts, Canadian customers were importing the goods and paying the Division III tax at the border. Despite the fact that the underlying sales agreements indicated that goods were being sold either FOB or CIF "in Canada", Toyota Tsusho was not charging the Division II tax. The Tax Court corrected that misapprehension, and then considered the application of penalties under section 280 of the *ETA*. The Court indicated that despite the fact that the taxpayer sought general advice from Revenue Canada and public accounting firm seminars and government publications, and believed its practices to be "intuitively correct", it ought to have "gone further and sought a precise focused opinion" as to how the ETA's Division II and Division III taxes actually worked.

1. Under those rules, for example, *goods* are sold "in Canada" if "delivered or made available in Canada" to the purchaser, and *services* are performed "in Canada" if "performed in whole or in part in Canada".

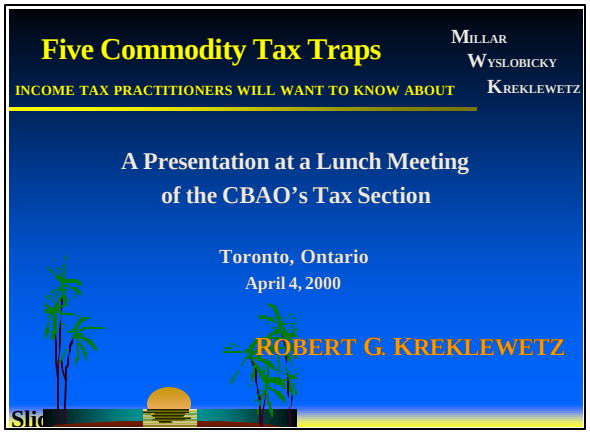
2. See *Toyota Tsusho America Inc. v. The Queen*, [1997] ETC 2941 (TCC).

3. Since the FCA's decision in *A-G Canada v. Consolidated Canadian Contractors Inc.*, [1998] 2965 ETC (FCA), it has been universally accepted that the seemingly automatic penalties imposed under section 280 of the ETA are susceptible to a defence of due diligence.

Five Commodity Tax Traps (Income Tax Practitioners Will Want to Know About)

ROBERT G. KREKLEWETZ

A Presentation at a Lunch Meeting of the CBAO's Tax Section (April 4, 2000: Toronto, Ontario)



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