COMMON COMMODITY TAX ISSUES
IN CORPORATE REORGANIZATIONS

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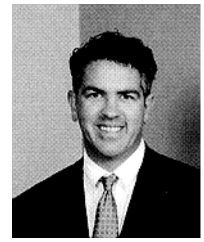

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MWK is a boutique tax law firm specializing in Commodity Tax and Customs & Trade matters including Tax & Trade Litigation.

Specialized Practice Area

Commodity Tax. Rob's practice focuses on taxes like Canada's federal Goods and Services Tax (GST/HST), and Canada's provincial sales taxes (e.g., Ontario retail sales tax, BC Social Services Tax), as well as all other "excise" taxes and duties (e.g., tobacco, alcohol, jewellery, and gasoline taxes).

Customs & Trade. Rob's practice focuses on all issues relating to Valuation, Tariff Classification, Origin, and Marking, as well as advising on NAFTA Origin Verification Reviews, Ascertained Forfeitures, Seizures, Export Control and Licensing Issues, Drawback, and other NAFTA & WTO matters.

Tax-Related Matters. Rob also advises on a number of other tax-related matters involving the global movement of goods, services and labour – examples of which include advising non-residents on establishing Canadian business operations (including the provision of transfer pricing advice); advising on the application of Canadian pay-roll source deduction taxes (e.g., Ontario EHT, and federal CPP or EI); and advising on all tax and licensing issues affecting the Canadian Direct Selling Industry.

Extensive Litigation Experience

Tax & Trade Litigation is an integral element of Rob's practice, with Rob acting as lead counsel in many 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.

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Blue Chip Client Base

MWK has some of the best tax and trade files in Canada, and Rob advises many blue chip corporate clients, who are national and international leaders in the following industry sectors:

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MWK also provides cost effective solutions for small to medium-sized businesses, and high net wealth entrepreneurs.

Speaking Engagements

Publications

Memberships

Rob has published over **250 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 like the Canadian Association of Importers & Exporters (CAIE), Canadian Tax Foundation (CTF), Canadian AND Ontario Bar Associations (CBA/OBA), Canadian Institute of Chartered Accountants (CICA), Canadian Finance and Leasing Association (CFLA), Certified General Accountants (CGA), and the Direct Sellers Association (DSA). Rob also speaks regularly at Professional Conferences held by the Strategy Institute, Infonex, IIR and Federated Press.

Rob is also a regular contributor on commodity tax and customs matters 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*, CAIE's *Tradeweek,* and Federated Press's *Sales and Commodity Tax Journal*.

Rob is a member of the OBA's Tax 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 5½ year-old boy named **William** (the "Conqueror"), who has a 6 month old little brother named **Richard** (the "Lion-Hearted").

While Rob concedes that Customs, Trade & Commodity Tax 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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INTRODUCTION

Understanding the application of Canada's various commodity taxes to corporate reorganizations is a challenging, but not an impossible endeavor. This paper focuses on some common commodity tax[1] issues involved in corporate reorganizations.

While the breadth of Canadian commodity taxes precludes a comprehensive discussion of all commodity tax issues involved in any given corporate reorganization, we have tried to focus on a few of the more interesting or common issues. Accordingly, the paper has been broken into three parts, as follows.

Part I provides a "building block" discussion, and recognizes that the level of discussion in each of the subsequent Parts is a fairly sophisticated one, necessarily assuming a significant degree of knowledge regarding the commodity tax systems in which the "common issues" arise. Accordingly, while Part I may be somewhat superfluous for the more acquainted reader, it will also serve as a useful leveler of the playing field facing the less-acquainted reader.

Part II focuses on the application of commodity taxes to reorganizations involving pure share and debt transactions.

Part III focuses on the application of commodity taxes to asset movements, and includes a discussion of the treatment of business asset acquisitions.

PART I – BUILDING BLOCKS

I - 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, [2] as well as most goods,[3] 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**
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DIVISION IV.1:	HST on Imported Supplies
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Under Division II of the *ETA*, for example, GST is imposed on domestic supplies, which are referred to as "taxable supplies made in Canada".[4] In turn, Division III imposes GST on most imported goods,[5] while Division IV imposes GST on a number of "imported taxable supplies" – which are defined to include certain services and intangibles acquired outside of Canada, but consumed, used or enjoyed in Canada.[6]

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,[7] that businesses with cross-border exposures in those provinces will now see that what was once a 7% risk, is now a 15% risk.

I - 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[8] 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[9] non-residents,[10] unregistered non-residents who carry on business in Canada, and supplies 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.

I - 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".[11]

A "taxable supply" is defined in section 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 "exempt" supplies that are enumerated in Schedule V of the *ETA*.[12]

I - 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".[13] 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 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).

I - 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.[14]

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

I - 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.

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.

I - 1.1(e) *Permanent Establishments*

Section 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.[15] 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.

I - 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.[16] 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 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".[17] 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.

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

The CCRA 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)

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 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.[18]

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.

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

Special rules in section 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.

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.[19] (See Figure 3).

I - 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 "commercial activities".[20] 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.

Figure 3: ***GST Registration***

Section 240 of the *ETA* provides for the GST Registration Rules. In terms of "mandatory" registration, section 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 section 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,

I - 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".[21] 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 in these types of cross-border transactions, with both Division II and Division III tax being payable in some instances.

I - 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 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.[22]

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.

I - 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 Imported 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 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.

I - 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.

I - 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.

I - 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[23] which is capable of capturing virtually all goods, as well 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.[24] 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.[25]

I - 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.

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

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.

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.

I - 2.2 Focus on Ontario PST

As indicated, and in terms of the provincial sales tax impact on corporate reorganizations, this Paper will focus on the application of the Ontario PST provided for in the Ontario *Retail Sales Tax Act* (the "*RSTA*").

PART II – COMMODITY TAX ISSUES INVOLVED IN SHARE/DEBT TRANSACTIONS

Transactions involving shares or debt are relatively simple from a commodity tax perspective. Accordingly, many corporate reorganizations involving pure share or debt transactions can be dealt with quite easily, using "first principles".

II - 1 COMMON GST ISSUES

II - 1.1 Share & Debt Transactions Exempt: Financial Services 101

From a GST perspective, transactions involving shares or debt are usually straightforward. This is because no GST applies to share or debt transfers.

This result really follows from first principles, and the definitions of "financial instrument" and "financial service" in the *ETA*, as well as the exemption provided for in Part VII of Schedule V of the *ETA*.

That is, "equity" and "debt" securities are defined as "financial instruments", and the "the *issue*, *granting*, *allotment*, *acceptance*, endorsement, renewal, processing, variation, *transfer of ownership* or repayment of a *financial instrument*" is defined to be a "financial service". (Figure 5a sets out all of the exempt "financial services", while Figure 5b describes the "financial instruments").

In turn, Part VII of Schedule V exempts virtually all domestic supplies of "financial services".

The exempt nature of share transactions makes the "purchase of shares" quite appealing in the corporate reorganization context, particularly as an alternative to the "purchase of assets". The share purchase will allow the purchaser to avoid the "cash-flow burden" of paying GST on the value of the assets acquired, and then waiting out the time for the available ITC.

Figure 5a: ***Exempt Financial Services***

Part VII of the *ETA* exempts the supply of domestic “financial services”, which are defined in section 123(1) as follows:

"financial service" means

(a) the exchange, payment, issue, receipt or transfer of money, whether effected by the exchange of currency, by crediting or debiting accounts or otherwise,

(b) the operation or maintenance of a savings, chequing, deposit, loan, charge or other account,

(c) the lending or borrowing of a financial instrument, *

(d) the issue, granting, allotment, acceptance, endorsement, renewal, processing, variation, transfer of ownership or repayment of a financial instrument,

(e) the provision, variation, release or receipt of a guarantee, an acceptance or an indemnity in respect of a financial instrument,

(f) the payment or receipt of money as dividends (other than patronage dividends), interest, principal, benefits or any similar payment or receipt of money in respect of a financial instrument,

(f.1) the payment or receipt of an amount in full or partial satisfaction of a claim arising under an insurance policy,

(g) the making of any advance, the granting of any credit or the lending of money,

(h) the underwriting of a financial instrument,

(i) any service provided pursuant to the terms and conditions of any agreement relating to payments of amounts for which a credit card voucher or charge card voucher has been issued,

(j) the service of investigating and recommending the compensation in satisfaction of a claim where … [certain conditions are specified]

(j.1) the service of providing an insurer or a person who supplies a service referred to in paragraph (j) with an appraisal of the damage caused to property, or in the case of a loss of property, the value of the property, where the supplier of the appraisal inspects the property, or in the case of a loss of the property, the last-known place where the property was situated before the loss,

(k) any supply deemed by subsection 150(1) or section 158 to be a supply of a financial service,

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

(m) a prescribed service,

but does not include

(n) the payment or receipt of money as consideration for the supply of property other than a financial instrument or of a service other than a financial service,

(o) the payment or receipt of money in settlement of a claim (other than a claim under an insurance policy) under a warranty, guarantee or similar arrangement in respect of property other than a financial instrument or a service other than a financial service,

(p) the service of providing advice, other than a service included in this definition because of paragraph (j) or (j.1),

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

(i) a management or administrative service, or

(ii) any other service (other than a prescribed service),

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

(r) a professional service provided by an accountant, actuary, lawyer or notary in the course of a professional practice,

(r.1) the arranging for the transfer of ownership of shares of a cooperative housing corporation,

(s) any service the supply of which is deemed under this Part to be a taxable supply, or

(t) a prescribed service;

* See *Figure 5b* regarding the meaning of the term “financial instrument”.

On the other hand, however, the exempt nature of share or debt transactions brings up other issues, like the availability of ITCs to recover GST paid on acquisition costs incurred in the course of the share purchase.[26] (The vendor also faces similar ITC issues respecting its disposition costs.)

The general rule is that since the share purchase transaction is an exempt activity, it may well be that no ITCs are recoverable. That forces one to look for special exemptions in the *ETA* – which one will see are both difficult to find, and difficult to fit into.

Figure 5b: ***Defined Financial Instruments***

The term "financial instrument" is defined in section 123(1) of the *ETA* as follows:

"financial instrument" means

(a) a debt security, *

(b) an equity security, **

(c) an insurance policy,

(d) an interest in a partnership, a trust or the estate of a deceased individual, or any right in respect of such an interest,

(e) a precious metal,

(f) an option or a contract for the future supply of a commodity, where the option or contract is traded on a recognized commodity exchange,

(g) a prescribed instrument,

(h) a guarantee, an acceptance or an indemnity in respect of anything described in paragraph (a), (b), (d), (e) or (g), or

(i) an option or a contract for the future supply of money or anything described in any of paragraphs (a) to (h);

* **Debt security** means "a right to be paid money and includes a deposit of money, but does not include a lease, licence or similar arrangement for the use of, or the right to use, property other than a financial instrument".

** **Equity security** means "a share of the capital stock of a corporation or any interest in or right to such a share".

II - 1.2 ITCs & Share Only Transactions

There is a real issue as to whether a special purpose vehicle, incorporated only to acquire, hold and/or sell shares, is entitled to even register for the GST, let alone attempt to claim ITCs. The simple reason is that both the GST registration process and ITC entitlement rules are predicated on "commercial activities" taking place; where share-only transactions are involved, however, there are no "commercial activities" taking place.[27]

II - 1.3 ITC Basics

To fully understand the issue, one has to understand the basis on which ITCs can be properly claimed under section 169 of the *ETA*.

For these purposes, section 169(1) contains 2 fundamental conditions that must be satisfied to claim ITCs: the first is that the person claiming an ITC must be a *registrant* during the reporting period" in which the tax became payable or was paid; the second is that the person is generally limited to claiming ITCs which reflect the extent (expressed as a percentage) to which the person acquired the property or services "for consumption, use or supply in the course of commercial activities of the person".

II - 1.4 The Registrant Point

In terms of the "registrant" point, since the "mandatory registration" requirement in section 240(1) – see again Figure 3 – does not *require* a person who is engaged in exempt activities to register for the GST,[28] the only manner in which such a person can ensure that it is a "registrant",[29] is to have actually become registered through the voluntary registration process. A person's ability to register "voluntarily", however, can be somewhat tenuous, since the "voluntary registration" rules in section 240(3) are generally predicated on at least some level of "commercial activity" taking place in Canada.

Accordingly, special purpose vehicles involved in corporate reorganizations often face a very real difficulty in (legitimately) meeting the "registrant" requirement.

One still sees this issue today, and it is usually dealt with in the following manner: ensure that the special purpose vehicle bought and sold some nominal property prior to attempting to voluntarily register, and has carried on a commercial activity for at least some threshold period.[30]

As the discussion below will indicate, special additions to the voluntary registration provision have helped certain corporate vehicles (e.g., holding companies) in certain situations, but for the most part, this basic issue has not been resolved (or otherwise dealt with) in the *ETA*.

II - 1.5 The Use in Commercial Activities Point

In terms of ITC entitlement in corporate reorganizations involving shares, the next real substantive issue will generally be the "extent to which" a person acquired the property or (usually) services "for consumption, use or supply in the course of commercial activities".

Generally, the conclusion ultimately made is that because of the exempt nature of the share transaction, there are no real "commercial activities" involved, and for that reason, no one (e.g., neither the transferor nor the transferee of the shares) is entitled to claim ITCs on the costs incurred to effect the transfer of shares.

Fortunately, some special rules do allow some limited relief, as set out below, although quite limited in nature, and directed at holding companies. In each case, specific requirements must be met, otherwise no special relief is available.

II - 1.6 Recovery of GST on Purchaser's Acquisition Costs

II - 1.6(a) *ITC Entitlement for "Takeover Fees"*

Section 186(2) of the *ETA* provides a special rule which can be used by an acquiring corporation ("A Co."), to claim ITCs in respect of GST paid on the goods and services associated with purchasing all or substantially all of the outstanding shares of a target corporation ("Targetco"). (See Figure 6).

Under this rule, A Co. must be a registrant and a resident of Canada. A Co. must also be either acquiring, or proposing to acquire, all or substantially all (i.e., at least 90%) of the outstanding voting shares of Targetco. Finally, the following condition must be met: during the *acquisition period*,[31] all or substantially all (at least 90%) of the *Targetco's property* must have been property that was acquired for use exclusively in commercial activities.[32]

Under these conditions, A Co. will be entitled to ITCs on goods and services purchased in relation to the acquisition or proposed acquisition of Targetco.

Figure 6: ***ITCs & Takeover Fees***

186 (2) **Takeover fees** — For the purposes of this Part, if

(a) a registrant that is a corporation resident in Canada (in this subsection referred to as the "purchaser") acquires, imports or brings into a participating province a particular property or service relating to the acquisition or proposed acquisition by it of all or substantially all of the issued and outstanding shares, having full voting rights under all circumstances, of the capital stock of another corporation, and

(b) throughout the period beginning when the performance of the particular service began or when the purchaser acquired, imported or brought into the participating province, as the case may be, the particular property and ending at the later of the times referred to in paragraph (c), all or substantially all of the property of the other corporation was property that was acquired or imported for consumption, use or supply exclusively in the course of commercial activities,

the particular property or service is deemed to have been acquired, imported or brought into the participating province for use exclusively in the course of commercial activities of the purchaser and, for the purpose of claiming an input tax credit, any tax in respect of the supply of the particular property or service to the purchaser, or the importation or bringing in of the particular property by the purchaser, is deemed to have become payable and been paid by the purchaser on the later of

(c) the later of the day the purchaser acquired all or substantially all of the shares and the day the intention to acquire the shares was abandoned, and

(d) the day the tax became payable or was paid by the purchaser.

The CCRA has indicated that so-called "creeping takeovers" are eligible under these rules, provided that A Co. can demonstrate that the subsequent share purchases were part of the initial proposal to acquire "all or substantially all" of the Targetco's voting shares.[33]

Given the discussion just above regarding "registrants" and the *ETA*'s registration requirements, persons wishing to take advantage of these rules will want to consider carefully whether they should be attempting register themselves at the earliest possible opportunity.

II - 1.6(b) ***Holding Companies***

Section 186(1) also provides special ITC rules for corporations with existing investments in related corporations. (See Figure 7).

This rule allows registrant corporations who are Canadian residents, and who have acquired goods or services for consumption or use "in relation to" shares or indebtedness of a related subsidiary corporation,[34] to claim ITCs for the GST paid in respect of such goods and services. Again, the secondary condition is that at the time the parent corporation incurred the expense, all or substantially all (90%) of the property of the related subsidiary corporation must been acquired for exclusive use in commercial activities.

The effect of section 186(1) is to allow a "parent" corporation to claim ITCs for all inputs, which were reasonably incurred in relation to the shares or indebtedness of the subsidiary. For example, to the extent a holding corporation acquires some additional shares in a related subsidiary, provided all of the section 186(1) requirements are satisfied, ITCs should be available for expenses incurred in relation to the acquisition of those additional shares.

Figure 7: ***ITC & Holding Companies***

186.(1) **Related corporations** — Where

(a) a registrant (in this subsection referred to as the "parent") that is a corporation resident in Canada at any time acquires, imports or brings into a participating province particular property or a service that can reasonably be regarded as having been so acquired, imported or brought into the province for consumption or use in relation to shares of the capital stock, or indebtedness, of another corporation that is at that time related to the parent, and

(b) at the time that tax in respect of the acquisition, importation or bringing in becomes payable, or is paid without having become payable, by the parent, all or substantially all of the property of the other corporation is property that was last acquired or imported by the other corporation for consumption, use or supply by the other corporation exclusively in the course of its commercial activities,

except where subsection (2) applies, for the purpose of determining an input tax credit of the parent, the parent is deemed to have acquired or imported the particular property or service or brought it into the participating province, as the case may be, for use in the course of commercial activities of the parent to the extent that the parent can reasonably be regarded as having so acquired or imported the particular property or service, or as having so brought it into the province, for consumption or use in relation to the shares or indebtedness.

Note: Section 126(2) of the *ETA* provides that a person is "related" if "related" under the rules in sections 251(2) to (6) of the *Income Tax Act*.

Holding companies satisfying the section 186(1) requirements and that are not registered, will want to consider recent changes to the "voluntary registration" requirements in section 240(3)(d)(i) of the *ETA*. Those rules mirror the requirements in section 186, with the end result being as follows: if a holding company qualifies for section 186 relief, but-for not being a registrant, it should now be entitled to register on a voluntary basis under section 240(3).[35]

As a final note, the types of goods and services that one is able to acquire as a holding company, and claim corresponding ITCs under section 186(1) are *not limited* to just direct costs related to shares or debts (e.g., legal and accounting fees on the purchase). The CCRA has indicated that "indirect costs" like administrative overhead, rent, utilities and fees incurred to prepare financial statements may be eligible.[36]

II - 1.6(c) *Multi-Tiered Corporations*

Section 186(3) extends the application of subsections 186(1) and (2) to multi-tiered corporations. (See Figure 8).

Figure 8: ***ITCs & Multi-Tiered Corporations***

186(3) **Shares, etc., held by corporation** — Where at any time all or substantially all of the property of a particular corporation is property that was acquired or imported by it for consumption, use or supply exclusively in the course of its commercial activities, all shares of the capital stock of the particular corporation owned by, and all indebtedness of the particular corporation owed to, any other corporation that is related to the particular corporation shall, for the purposes of this section, be deemed to be, at that time, property that was acquired by the other corporation for use exclusively in the course of its commercial activities.

For example, where Targetco is itself just a holding corporation, it is unlikely that section 186(2) would apply, since it requires 90% of Targetco's assets to be used in commercial activities. With the addition of section 186(3), however, the shares owned by Targetco (i.e., in the further subsidiary beneath it, or "Subco") will be deemed to be held by Targetco as "property that was acquired … for use exclusively in the course of its commercial activities". That means that provided Subco's assets were acquired for "use exclusively in commercial activities", Targetco's assets will be deemed to be held in the same manner, making the section 186(1) and (2) rules work in respect of Targetco.

The CCRA has indicated that section 186(3) can be used in a multi-tiered corporate structure and that there are no limits to the number of layers of holding companies.[37]

II - 1.7 Possible Recovery of Vendor's Disposition Costs?

II - 1.7(a) *Section 185*

Section 185 of the *ETA* is a special provision designed to allow non-financial institutions, with certain incidental financial service activities that "relate to" their commercial activities, to claim full ITCs without having to apportion their ITC claims between their taxable and exempt activities. (See Figure 9).

Figure 9: ***Possible ITCs on Vendor Dispositions***

185.(1) **Financial services - input tax credits** — Where tax in respect of property or a service acquired, imported or brought into a participating province by a registrant becomes payable by the registrant at a time when the registrant is neither a listed financial institution nor a person who is a financial institution because of paragraph 149(1)(b), for the purpose of determining an input tax credit of the registrant in respect of the property or service and for the purposes of Subdivision d, to the extent (determined in accordance with subsection 141.01(2)) that the property or service was acquired, imported or brought into the province, as the case may be, for consumption, use or supply in the course of making supplies of financial services that relate to commercial activities of the registrant,

(a) where the registrant is a financial institution because of paragraph 149(1)(c), the property or service is deemed, notwithstanding subsection 141.01(2), to have been so acquired, imported or brought into the province for consumption, use or supply in the course of those commercial activities except to the extent that the property or service was so acquired, imported or brought into the province for consumption, use or supply in the course of activities of the registrant that relate to

(i) credit cards or charge cards issued by the registrant, or

(ii) the making of any advance, the lending of money or the granting of any credit; and

(b) in any other case, the property or service is deemed, notwithstanding subsection 141.01(2), to have been so acquired, imported or brought into the province for consumption, use or supply in the course of those commercial activities.

Section 185 deems GST that is payable by a registrant for property or services acquired for "consumption, use or supply in the course of *making supplies* of financial services that relate to commercial activities of the registrant", to have been acquired or used in the course of commercial activities.

To rely on section 185, the "making supplies of financial services" (i.e. selling the shares) must "relate to" the commercial activities of the registrant.

Accordingly, it may be useful for claiming ITCs when a corporation is issuing treasury shares or arranging debt financing to raise capital.

Generally, the incoming capital will be used in the issuer's business and, as such, will "relate to" the registrant's commercial activities, thereby deeming the costs incurred in issuing these shares to be used in the course of the registrant's commercial activities.

The CCRA has taken a similar position in Policy Statement P-108, allowing ITCs in respect to fees incurred in relation to the issuance of shares. The CCRA has also confirmed the availability of ITCs in respect to legal fees and accounting fees arising out of an issuance of shares by prospectus.[38]

II - 1.7(b) ***Section 186***

Provided all of the requirements for subsection 186(1) (as discussed above) have been met, this section can also be used to recover the vendor's disposition costs provided the costs were incurred at a time when the vendor corporation was related to the operating company. In this regard, to satisfy the related requirement, the services must have been acquired before the shares were sold since after the share sale, the vendor will not be related to the operating company.

II - 1.7(c) ***ITC's For Targetco In Defending or Defeating Takeover Bids***

In terms of takeover bids, it is interesting to note that the CCRA historically rejected claims for ITCs made by a take-over target, for GST incurred in either accepting or defending the takeover bid. That position only changed after it was challenged in the Tax Court, in *BJ Services,*[39] and the Tax Court concluded that ITCs were available.

In *BJ Services*, the Tax Court rejected the CCRA's position and held that expenses incurred by the target company (Nowsco Well Service Ltd.) to – in this situation – resist a hostile takeover launched by BJ Services, were fully recoverable through ITCs. In allowing the ITC claim, the Court focused primarily on the ITC requirements in section 169 and noted that the target "did not make any exempt supplies" since it was the shareholders who transferred the GST exempt shares. Accordingly, based on the Court's analysis, it would appear that GST registrants, who are engaged exclusively in commercial activities, can properly claim ITCs for expenses incurred in relation to a takeover bid.

II - 1.7(d) ***ITC's For Regular On-Going Corporate Matters***

While the CCRA's position on this point has now changed, it is noteworthy that the CCRA has always accepted that ITCs are permitted for regular ongoing corporate and securities matters, providing as follows:[40]

> Under certain circumstances, for example, take-over bids, the fulfilling of obligations under corporate or securities law in producing and distributing circulars for shareholders, which may include legal and accounting fees (charged by outside experts), valuation reports, fairness opinions, printing costs and mailing costs, has been considered to have been incurred for the purpose of making supplies for consideration in the course of the corporation's endeavour for purposes of section 141.01. Although securities or corporations law may not specifically require the hiring of outside experts, the corporate directors have little choice except to rely on reports of lawyers, accountants, engineers, appraisers or other persons whose profession lends credibility.

> The costs at issue [i.e., enhancing shareholders value] do not fall into this category [i.e., the previously excluded category for expenses involving "enhancing shareholder value"].

II - 1.7(e) *ITC's For Employee Relocation Costs*

From time to time, corporate reorganizations come with costs associated with relocating employees. In the *Zellers*[41] case, the Tax Court has recently clarified that a corporation is entitled to claim ITCs, pursuant to section 174, in respect of certain employee relocation allowances that it pays to its employees.

Section 174 of the *ETA* is a deeming provision that allows a corporation (among others) to claim an ITC in respect of certain allowances that it has paid to its employees, as if it had incurred the expense directly (and paid the GST directly), provided that the conditions of the section are met. Zellers had paid allowances to its employees that were relocated to reimburse them for their direct and actual moving expenses as well as an allowance equal to 10% of the employee's salary, to cover the additional costs of relocating (e.g., installation of cable, telephone and utilities). The central issue in the case was whether the relocation allowances were in relation to the commercial activities of Zellers or whether they were simply personal expenses of the employees.

The Tax Court concluded that the allowances in fact related to Zellers' commercial activities, and gave a broad interpretation to section 174 saying that they were "essential to the growth and economic viability" of Zellers. Accordingly, Zellers was entitled to ITCs based on 7/107ths of the relocation allowances it had paid to its employees.

Zellers, then, establishes an important principle in employee relocation cases.

II - 1.8 GST & Due Diligence on Share Purchases

The last point to note for persons involved in corporate reorganizations involving shares only is that "due diligence" investigations should include careful attention to potential GST issues.

The GST has only been exigible in Canada for about 12 years, and some (usually small) businesses have yet to undergo even their first GST audit.

Accordingly, the purchaser of a business should attempt to quantify and limit any potential GST liability that it will be assuming when it acquires a business through purchasing all of its shares. This should be achieved through ensuring that GST returns have been filed by the target corporation for the past four years, and attempting to verify, as best as possible, that the correct amount of tax has been paid or remitted, that ITCs have not been claimed in respect of materials used to make exempt supplies, and so on.

Where pregnant issues are inherited, the *ETA* provides for a normal four year assessment period, and for an indefinite assessment period where fraud is alleged, or where it is alleged that a "misrepresentation" was made that was "attributable" to a person's "neglect, carelessness or wilful default".[42]

II - 2 COMMON PST ISSUES

The Ontario PST issues relating to pure share and pure debt transactions are non-existent.

The reason is that while taxing TPP and some services, the *RSTA* does not tax transactions involving intangibles like shares or debt securities.

Where Ontario PST does become relevant is where shares or debt are exchanged (or used as other consideration) for tangible assets. The PST issues arising from those sorts of transactions will be canvassed in Part III of the Paper, below.

PART III – DEALING WITH ASSET MOVEMENT ON REORGANIZATIONS

Unlike the application of the GST to pure share or debt transactions, where a corporate reorganization includes asset transfers involving tangible goods, services or intangibles, more involved issues arise.

III - 1 COMMON GST ISSUES

III - 1.1 Acquisition of Business Assets – *Less than* a Business

There are special GST rules available in certain instances where a business or part of a business is acquired. These are found in section 167 of the *ETA*, and are discussed further below.

In the absence of those special rules applying – which may well be the case in more situations than one would generally expect – an "asset-by-asset" review must be undertaken to determine where and how the GST applies.

In undertaking an "asset-by-asset" review, there would usually be no issue as to whether the assets being acquired are being supplied in Canada,[43] so the review would fall to a question of whether the particular assets were "taxable", "exempt" or "zero-rated".

As a general rule, one will usually find that most business assets (e.g., inventory, equipment, intangible property, etc.) are "taxable" for GST purposes. Thus a purchaser would be required to pay the GST, and recover it by way of ITCs – if the business assets are intended for use in commercial activities.

While a complete discussion of the GST treatment of all possible business assets is beyond the scope of this paper, Figure 10 summarizes the treatment afforded to some common assets.[44]

Some further special situations would be as follows.

Figure 10: ***The Application of the GST to Common Business Assets***

Capital Real Property		**Capital Personal Property**	
Examples:	Land Buildings	*Examples:*	Production Machinery, Motor Vehicles, Office Furniture
GST Status:	Taxable / Special Remittance Rule	*GST Status:*	Taxable, but ITCs
Financial Assets		**Goodwill**	
Examples:	Bank Accounts, Investments Accounts Receivable	*Examples:*	n.a.
GST Status:	Exempt	*GST Status:*	Taxable, but possible collection relief.
Pre-Paid Contracts		**IPP**	
Examples:	Pre-paid Insurance Pre-paid Services Contract	*Examples:*	Trademark, Patent Copyright
GST Status:	Depends on Underlying Supply	*GST Status:*	Taxable, but ITCs

III - 1.1(a) ***Acquiring Land or Other Capital Real Property***

"Capital real property"[45] is taxable for GST purposes, although a special remittance rule usually applies.

The special remittance rule is found in subsection 221(2) of the *ETA* and relieves the purchaser from having to pay GST to the vendor on purchases of real property where (a) the vendor is a non-resident or is considered a resident only because of special deeming rules (for example, by maintaining a permanent establishment in Canada);[46] or (b) where the purchaser is registered and, if the purchaser is an individual, the supply is not a supply of a "residential complex" or cemetery plot.[47]

Where subsection 221(2) applies, the vendor is relieved from its obligation to charge GST, and the purchaser is specifically required not to pay the GST to the vendor. Subsection 228(4) thus imposes a corresponding obligation directly on the purchaser, and provides that when the purchaser falls under the special non-collections rule in subsection 221(2)(b) (e.g., because the purchaser is a GST registered corporation), and provided that the purchaser is acquiring "the property for use or supply *primarily* in the course of commercial activities", then the purchaser must self-assess the amount of the GST owing, and report and remit the GST with its regular GST return. In this process, the purchaser would be able to offset the GST required to be remitted with an ITC claim, all in the same return.

If the purchaser falls within the special non-collection rule in subsection 221(2)(b), but is *not* acquiring "the property for use or supply primarily in the course of commercial activities", then subsection 228(4)(b) is applicable, and requires the purchaser to prepare and file Form GST 60 "on or before the last day of the month following the month in which the tax became payable".[48]

While the cash flow advantages offered by subsection 221(2)(b) are significant, relying on this provision does involve some risk to a resident vendor. As noted above, a purchaser must be *registered* (i.e., not simply a "registrant") before subsection 221(2)(b) will apply. Accordingly, vendors relying on subsection 221(2)(b) must ensure that the purchaser is in fact registered for GST purposes at closing. To date, the CCRA generally considers vendors who incorrectly conclude that a purchaser is registered – and thus fail to collect tax in accordance with the general rule under subsection 221(1) – as assessable for the tax not collected, including interest and penalty (even in instances where the vendor reached such a conclusion after reasonable inquiries).

To highlight some of the risks surrounding real property transactions, one has to look no further than the Tax Court's decision in *Franklin Estates Inc. v. The Queen* [1994] 2 G.T.C. 1063. In *Franklin Estates*, subsection 221(2) relief was available to the purchaser, however, the purchaser mistakenly paid the vendor the GST applicable on the purchase, to the vendor. Unfortunately for the purchaser, the Court held that when the conditions in section 221(2) are satisfied, it was mandatory for the purchaser to remit the GST under the special non-collections rule (i.e., self-assess). Accordingly, the vendor was not held to be acting as an agent for the Crown for the purposes of collecting the tax and, as a result, the purchaser was still required to remit and report the applicable GST to the CCRA (i.e., pay the tax twice).

This risk is further exacerbated by the absence of any procedure for a vendor to obtain a pre-clearance certificate from the CCRA stating that a particular purchaser is registered. Currently, the CCRA attempts to alleviate the uncertainty confronting vendors by either confirming or denying, by telephone, registration information put before them. A vendor's solicitor can therefore telephone the CCRA's local district office and inquire as to whether a named purchaser is registered under a specific registration number, and whether such a purchaser remains registered under that registration number.

Given the impact the purchaser's registration status has on the collection of GST, we often recommend that the vendor call the CCRA twice to confirm a purchaser's registration status: once when the GST issues of the transaction are being negotiated; and a second time just prior to closing the transaction.

III - 1.1(b) ***Acquiring Capital Personal Property***

Capital personal property includes production machinery and equipment, motor vehicles and office furniture.

Capital personal property is generally subject to GST, although to the extent the assets were purchased for use in the course of the purchaser's commercial activities, ITCs would be available to recover this tax. Special deeming rules exist depending on the degree of use in commercial activities, however.

Advisors should note, however, that where immediately before the transfer, the capital personal property (other than certain vehicles and aircraft) was being used by a registrant vendor "otherwise than primarily in commercial activities" (i.e., being used primarily in exempt activities), then other special rules might apply to deem the supply to be made *not* in the course of commercial activities, and therefore non-taxable from the outset: see, for example, paragraph 141.1(1)(b), or subsection 200(3) – both of which go to similar effects and are, in certain instances, duplicative.

III - 1.1(c) ***Acquiring Accounts Receivable***

When accounts receivable are acquired, some special GST considerations arise. While the acquisition is generally exempt (i.e., a financial service), the real issues arise when collection attempts fail, and the transferee is left with a bad debt.

Bad debts, of course, contain an element of the GST – since the original vendor would have been required to charge, collect and remit the GST on the "credit sale", and should technically have remitted the GST some time prior to its assignment of the accounts receivable. While the *ETA* has some rules for recovering bad debts,[49] they do not work in the context of an assignment since bad debt relief is only available to the person who made the supply from which the account receivable arose (i.e., the original vendor). Accordingly, where accounts receivable are assigned, there is a real risk that any resulting bad debts would carry unrecoverable GST – both to the assignee and the assignor. Despite recent changes to these rules, this problem has not been addressed.

Fortunately, the CCRA does make an exception where accounts receivable are assigned on a full recourse basis. In its Policy P-029R (*Assignment of Accounts Receivable*, January 4, 1999), the CCRA indicates that the vendor of the accounts receivable can claim a reduction in net tax if re-purchasing the bad debt.

III - 1.1(d) ***Acquiring Goodwill***

As a form of intangible property, goodwill is – at least on a primary analysis – subject to GST when transferred. There are, however, special rules in section 167.1 for supplies of goodwill when supplied as part of the transfer of all or substantially all of the assets of a business.

Although "goodwill" is not defined in the *ETA*,[50] by its nature, it usually cannot be divorced from the business, and cannot be sold separately (i.e., it does not have value on its own but is derived from operating a business and generally represents the premium paid for a business in excess of the businesses' net assets). Accordingly, goodwill can generally be viewed as non-taxable (under section 167.1) in situations where – like for the section 167 election – the purchaser is acquiring a business or part of a business and all or substantially all of the assets used in the business (see discussion below). Unlike section 167, however, section 167.1 does not require any election.

III - 1.1(e) ***Acquiring Customer Lists***

Customer lists are personal property that the CCRA has recently confirmed, can be "produced" for purposes of subsection 141.1(1)(a) and (b) of the *ETA*.[51]

Section 141.1 deems certain transactions pertaining to the sale of personal property to be *either* supplies made "in the course of commercial activities" (i.e., which would be subject to GST), or supplies made outside the course of commercial activities (i.e., which would <u>not</u> be subject to GST). The line of demarcation is the purpose for which the personal property was initially acquired, imported, manufactured or produced (generally, in this section, "obtained").

Accordingly, where a good (like a customer list) is "obtained" for consumption or use in "commercial activities" (e.g., by a automobile retailer), its subsequent supply would be subject to GST. On the other hand, where the customer list was "obtained" for consumption or use in "non-commercial activities" (e.g., by an insurance company), its subsequent supply would <u>not</u> be subject to GST.

Thus the GST status of a "customer lists" – and other personal property being sold – depends on whether it was acquired, imported, manufactured or produced in or outside of the course of commercial activities.

The main reason for this rule is to allow exempt businesses to sell their business assets without creating a cascading of GST. In the absence of the rule, the GST would cascade on the sale of these types of assets, as the exempt user, selling the assets, would already have paid unrecovered GST on the acquisition of the asset, only to have to charge to new owner further GST.

There was some historic uncertainty as to whether intangible property, like a customer list, could qualify for the relief provided for by subsection 141.1(b), and the CCRA clarified that they could so qualify, in its GST Policy P-242.

Even where a customer list is "taxable", there may be other rules which afford some relief, as for example, section 167 of the *ETA* (see below).

Accordingly, customer lists that are produced in the course of commercial activities and sold as part of the sale of the business, where sections 167 or 167.1 do not apply, are subject to GST. On the other hand, customer lists that are not produced in the course of commercial activities (i.e., exempt activities) will not be subject to GST.

III - 1.2 **Acquiring "a Business" or "Part of a Business" – Possible S. 167 Relief**

As alluded to above, special GST relief may be available to a person who acquires "a business" or a "part of a business". The rules are subject to some stringent conditions, however, each of which must be met in order to take advantage of the GST relief.

III - 1.2(a) ***Section 167 Relief***

Section 167 is the *ETA*'s "roll-over" provision, and enables most parties to engage in the sale of a business without any GST effect. Having said that, there are still some technical considerations to be met – as well as well as a filing requirement, which is often necessary to "perfect" the relief.

III - 1.2(b) ***Basic Rules***

Section 167 applies where there is a (1) sale of a business, or part of a business, and the (2) 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 of the business as a business".[52] If that test has been met, a joint election must be made by the vendor and purchaser (in Form GST 44).

III - 1.2(c) ***Commentary***

Some commentary is warranted. First, the rule requires the purchaser to acquire a "business". Second, the purchaser must also be acquiring ownership, possession or use of "all or substantially all" of the assets which are reasonably necessary for the purchaser to be capable of carrying on the business or part of the business. The CCRA considers "all or substantially all" to mean 90% or more. However, this 90% threshold would not seem to apply to assets which are not necessary to carrying on the business like, for example, accounts receivables, working capital, bank accounts, etc. Further, recent case law has also confirmed that the CCRA's 90% arbitrary test for “substantially all” is only a guideline at most.[53]

Irrespective of what percentage amounts to “all or substantially all”, there is no requirement on the purchaser to *purchase* “all or substantially all” of the vendor’s assets. The *ETA* specifies that the purchaser must obtain, under the agreement of purchase and sale, only *use* to “all or substantially all” of the vendor’s assets and, as such, some of the assets may be leased instead of purchased.

As an example of the “all or substantially all” requirement in operation, consider the following example. A purchaser is acquiring a distribution business, composed of the following assets: i) warehouse; ii) fleet of delivery vehicles; iii) shipping and handling equipment used inside the warehouse; and (iv) accounts receivables, prepaid expenses, and contracts for the future supply of goods. This purchase would appear to fall within the scope of section 167 provided the portfolio of assets purchased is equivalent to 90% of the requisite assets (which in all likelihood would only be assets (i) through (iii)).

In the situation where the purchaser already operates a similar business, and is acquiring the assets to incorporate into its existing business, the purchaser may decide not to acquire all of the vendor’s assets. For example, in the above example, it is quite plausible that the purchaser would not acquire the warehouse if it has an existing warehouse. In this situation, if the warehouse represented more than 10% of all the assets needed to operate the vendor’s business, then a real issue arises as to whether section 167 may be used.

Although section 167 would appear to still apply since the purchaser does not need the warehouse “to be capable of carrying on the business”, the CCRA does not interpret section 167 in this manner. The CCRA takes a more restrictive approach to the phrase “under the agreement for the supply, the recipient is acquiring … all or substantially all of the property … necessary *for the recipient* to be capable of carrying on the business or part as a business”.

See, for example, GST/HST policy P-188, where the test for 167 is stated as follows:

> The recipient must be capable of carrying on the same kind of business that was established or carried on by the supplier *with the property that the recipient has acquired under the agreement.*
>
> [emphasis added]

In other words, the CCRA ignores the recipient’s existing property, only looking to the property acquired under the agreement to determine whether the “all or substantially all” test is satisfied.

The CCRA recently confirmed its position at the CCRA and Canadian Bar Association (Sales and Commodity Tax Section), Annual Meeting, February 27, 2003.[54] In addressing a hypothetical situation involving the purchase of a fertilizer business, where the purchaser failed to acquire certain assets – namely, the factory and equipment, which the purchaser already had – the CCRA advised as follows:

> It appears from the facts provided that Company A is supplying trademarks, contracts and goodwill that were used in its fertilizer division, but not the factory or equipment used to produce the fertilizer. ~~These three items supplied alone do not appear to constitute a business or part of a business carried on by Company A~~.
>
> > Subsection 167(1) also requires that *under the agreement for the supply*, the recipient 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. Since "all or substantially all" is generally interpreted to mean at least 90%, any property not acquired under the agreement for the supply but that the recipient requires to carry on the business must fall within the remaining general margin of 10% of the fair market value of all the property acquired. Based on the information provided, it does not appear that the assets being supplied by Company A and acquired by Company B are sufficient to meet this requirement.

The CCRA's interpretation of the "all or substantially all" test is overly restrictive and does not appear to be consistent with the legislation, which seems to clearly provide that the "all or substantially all" test should looked at *from the purchaser's perspective*, with the determination being whether the purchaser has acquired the assets which *it needs* to operate the business. From a more common sense approach, and by looking at the two requirements together, the CCRA's interpretation may be justified, since without the warehouse, the purchaser may not have acquired an "established business" or "part of a business" – and may only have really acquired a small part of the assets of a business.

Although there is very little case law addressing the section 167 requirements, the Tax Court's simplistic analysis in *Cinnamon City Bakery* [2001] G.S.T.C. 134 is worth noting:

> The Appellant sold fully operating cafés to the franchisees. Such arrangements included the necessary premises, equipment and inventory to operate the cafés. I therefore conclude that the sale of the franchises was a supply of a "business that was established" pursuant to subsection 167(1).
>
> The second condition is that the recipient acquires possession or use of all or substantially all of the property required to carry out the business. The franchisees acquired fully operating or ready to operate entities. I therefore conclude the franchisees acquired all or substantially all of the property necessary for the franchises to carry on the business.

Finally, and as alluded to in the *Cinnamon City Bakery* case, there are special limitations to the relief that is available under section 167.

For example, relief under section 167 will not extend to taxable services that "are to be rendered by the supplier", taxable supplies of property by way of "lease, licence or similar arrangement", or sales of real property (unless the purchaser is a registrant) – even though these assets will count in the "all or substantially all" calculation. For assets acquired in this manner, section 167 relief is not available for the particular assets – even where the payments are made on a lump sum basis. For example, in addressing the availability of the section 167 rollover for a turn-key franchise, the Court in *Cinnamon City Bakery* held that a franchise fee was not entirely covered by the election since the franchisee was paying, in part, for the right to use the franchisor's trade name and for "training services".

Figure 11: ***Simple 167 Analysis***

Facts: Mco is considering purchasing Wco's perogy distribution business, which is comprised of a warehouse, fleet delivery vehicles, cooling equipment, shipping and handling equipment, accounts receivables, prepaid expenses, contracts for the future supply of goods, a whole bunch of perogy inventory, and a "key-man" agreement with the head perogy roller, K. Mco is GST registered.

Analysis: On the assumption that Mco is acquiring virtually everything that it will require to carry on Wco's business, the purchase can fall within the scope of section 167.

Additional Facts: Assume Mco decides not to purchase the fleet of delivery vehicles as he already owns delivery vehicles.

Additional Analysis: The transaction can still qualify for the exemption provided that the value of the delivery vehicles is less than 10% of the value of all of other requisite assets. In this calculation, an open issue exists in our mind as to whether or not the value associated with some of the assets needs to be included in the formula (e.g., the pre-paid expenses, the contracts for future supplies, and the perogy inventory). The uncertainty lies in assessing whether it can be reasonably said that the items are "necessary" to carry on this business – and an understanding of whether the purchaser must instantaneously be able to carry on the business. Why, for example, could a distribution business not be acquired *without* existing inventory, but with the intentions of replacing it immediately ?

(See Figure 11 for a simple example of a section 167 situation).[55]

In summary, the CCRA continues to take a restrictive approach to the application of section 167, therefore, careful consideration should be given to the requirements of the provision and each asset must be examined, in turn, to determine the application of GST.

III - 1.2(d) *Late Filed Section 167 Elections*

The CCRA has also recently indicated[56] that it will accept late filed section 167 elections and will apply the following guidelines in determining whether to accept the late filed election:

- if extenuating circumstances prevented the parties from filing the election by the required date;
- if the parties clearly met the criteria for making the election;
- if both parties conducted themselves at all times as if the election had been made;
- if there is no revenue loss to the government.

The CCRA also indicates that it will consider applying its wash transaction policy in these situations – hopefully, on the basis that filing the election late is akin to making a voluntary disclosure which results in no additional penalties or interest.

III - 1.2(e) *Alternatives to Section 167*

In situations where the vendor refuses to make the joint election, the purchaser is left with no alternative but to pay any GST that is applicable and apply for the ITC.

Where the amount of GST owing is substantial, the purchaser should consider making a formal request to the Summerside Tax Centre to have its GST return processed on an expedited basis. The purchaser might also consider negotiating with the vendor to have the GST collected at the end of the first month following the vendor's reporting period in which the supply occurred, as this is when the vendor is required to remit any tax collected on the sale (otherwise the vendor would have access to the GST prior to it being remitted to the CCRA). With a negotiated mechanism in place, the vendor does not have unnecessary access to the purchaser's funds before they are remitted to the CCRA, while the purchaser can forego any related adverse cash flow consequences.[57]

III - 1.3 Treatment Of Closely Related Corporations

The *ETA* also contains special provisions aimed at transfers between "specified members" of closely related groups ("qualifying groups"). These transfers will be treated as non-taxable for GST purposes, provided all the requirements are met, and a section 156 election is made.[58]

The effect of this election is to treat most transfers amongst corporations in a closely-related group as if they were transferred for "no consideration" – making the GST applicable to such supplies "nil".[59] For both the purchaser and vendor to be specified members of a closely related group, they must both be:

1. Canadian resident corporations (or Canadian resident partnerships);
2. Closely related to each other;
3. GST registrants;
4. Use all or substantially all of their property exclusively in the course of commercial activities or, in the situation where they have no property, all or substantially all of their supplies must be made in the course of commercial activities; and
5. Not have been a party to an election under subsection 150(1).[60]

Based on these requirements, the *ETA*'s closely related corporations rules tend to provide little assistance to non-residents involved in cross-border business acquisitions, however, they are useful for transfers between closely related domestic parties.

Note that the term "closely related" is fairly complex (likely necessitating a review of the rules on a case-by-case basis), but essentially requires 90% ownership of common shares.

III - 1.3(a) *New Corporations & Section 156*

Where a new corporation is incorporated solely for purposes of reorganizing assets between related parties, practitioners must ensure that the requirements of section 156 are satisfied.

As indicated above, all or substantially all of the new corporation's property must be used exclusively in the course of commercial activities (or, in the situation where it has no property, all or substantially all of its supplies must have been made in the course of commercial activities).

As new corporations generally do not have any property, and have not made any taxable supplies, *it must acquire at least some property prior to making a section 156 election*.[61]

Although the definition of "property" is quite broad, it specifically excludes money and, as such, opening a bank account is not sufficient.

We often suggest that new corporations acquire some tangible property such as office supplies before it uses the election. By doing this, provided the property is for exclusive use in its commercial activities and the other requirements are satisfied, the section 156 election should be available.

III - 1.4 Transfers Between Related Parties & Anti-Avoidance & Derivative Liability Provisions

Where the corporate reorganization involves related parties, and the transfer of GST taxable property, section 325 of the *ETA* becomes relevant.

Section 325(1) effectively provides an anti-avoidance rule for non-arm's length transfers of property, and imposes a derivative liability on a non-arm's length transferee of property, for any outstanding GST remittances. The liability is joint and several, but limited by the fair market value of the consideration paid for the assets (e.g., if full value is paid, there is no joint or several liability; if less than full value is paid, the liability is for the short-paid amount).[62]

Significantly, while section 325 limits, in some respect, the amount of the derivative liability on the transferee, there is no limitation on the liability on the transferor, which would fall under the general rules in the *ETA*.

Figure 13: ***GST & Wind-Ups***

272. Winding-up — Where at any time a particular corporation is wound up and not less than 90% of the issued shares of each class of the capital stock of the particular corporation were, immediately before that time, owned by another corporation,

(a) for the purposes of applying the provisions of this Part in respect of property or a service acquired, imported or brought into a participating province by the other corporation as a consequence of the winding-up, for the purposes of sections 231 and 249, and for prescribed purposes, the other corporation shall be deemed to be the same corporation as, and a continuation of, the particular corporation; and

(b) for the purposes of this Part, the transfer of any property to the other corporation as a consequence of the winding-up shall be deemed not to be a supply.

III - 1.5 Amalgamations

Section 271 of the *ETA* deals with how the GST applies to "amalgamations". Under that rule, where two or more corporations are merged or amalgamated to form one single corporation, the consequential transfer of any property to the new amalgamated corporation is generally deemed not to be a supply. That means that no GST would apply. (See Figure 12)

Figure 12: ***GST & Amalgamations***

271. **Amalgamations** — Where two or more corporations (each of which is referred to in this section as a "predecessor") are merged or amalgamated to form one corporation (in this section referred to as the "new corporation"), otherwise than as the result of the acquisition of property of one corporation by another corporation pursuant to the purchase of the property by the other corporation or as the result of the distribution of the property to the other corporation on the winding-up of the corporation,

(a) except as otherwise provided in this Part, the new corporation shall, for the purposes of this Part, be deemed to be a separate person from each of the predecessors;

(b) for the purposes of applying the provisions of this Part in respect of property or a service acquired, imported or brought into a participating province by a predecessor, for the purposes of sections 231 and 249, and for prescribed purposes, the new corporation shall be deemed to be the same corporation as, and a continuation of, each predecessor; and

(c) for the purposes of this Part, the transfer of any property by a predecessor to the new corporation as a consequence of the merger or amalgamation shall be deemed not to be a supply.

While the new amalgamated corporation is generally deemed to be a separate person from the predecessor corporations, the amalgamated corporation is deemed for most GST purposes, including bad debt relief under section 231 and those prescribed by regulation,[63] to be the same corporation as the predecessor corporation.

The CCRA's administrative position on "amalgamations" is set out in Policy P-045 (Butterfly Transactions) and GST Memorandum 2.7 (Cancellation of Registration), indicating that the newly amalgamated corporation is required to register (using the same registration number of one of the predecessor corporations if it chooses) and that it is eligible for ITCs in respect of GST paid on goods and services acquired to effect the transfer of assets.

III - 1.6 Winding-Up

Section 272 of the *ETA* provides special rules for wind-ups. (See Figure 13). Under the rule, where a corporation's shares are at least 90% owned by another corporation (e.g., Parent Co.), section 272 deems the transfer of assets to Parent Co., on a wind-up, not to be a supply. Again, no GST would apply. In this situation, Parent Co. is also deemed to be the same corporation as the subsidiary for bad debt relief and various purposes prescribed by regulation.

III - 1.7 Partnerships

The treatment of partnership transactions is beyond the scope of this paper. The GST rules for many partnership transactions are codified in section 272.1 of the *ETA*, and the CCRA, at the time of writing, has published at least two draft administrative policies describing its views on how these rules work.

III - 2 COMMON PST ISSUES

Like the GST situation, where assets are sold separately, PST generally applies. While the purchaser is required to pay the PST under subsection 2(1) of the *RSTA*, the vendor is usually required to collect the tax, at the time of the sale.[64]

III - 2.1 Tax Base Issues

Unlike the GST situation, the Ontario tax is levied predominantly on goods only. While there are some "taxable services", the enumerated services do not include services that one would normally see being sold as part of a corporate reorganization (e.g., key employee agreements, non-compete covenants, etc.).

Likewise, there are no "intangibles" that are taxed – with the notable exception being "computer programs" which are subject to tax, but as specially defined TPP. Thus, for example, intangible assets such as cash, accounts receivable, goodwill, trademarks, licenses, shares, and other financial instruments do not constitute TPP or goods and as such are not subject to PST.

Similarly, fixtures are generally considered to be real property and are not subject to PST.

As can been seen, then, the application of the PST to business assets is much like that under the GST, and requires an "asset-by-asset" approach.

III - 2.2 Asset-By-Asset Analysis – Ontario PST

While the PST treatment of some common business assets is considered below, the general rule is that if the asset is "tangible" (e.g., TPP), it is taxable unless there is an available exemption.

III - 2.2(a) *Inventory - Finished Goods (For Resale)*

Under the "to every rule there is an exception", the first exception to the general rule set out just above is that in Ontario, items purchased for resale are "non-taxable".[65] The predominant reason is that the purchaser of a good "for resale" is not purchasing the good to "consume" or "use" it, which is a condition to the tax being imposed under section 2(1) of the *RSTA*. While a more detailed explanation is probably in order, suffice to say that the non-taxable nature of "goods purchased for resale" is a virtual certainty, if only for constitutional reasons.[66]

Although "purchases for resale" do not technically attract PST, there are documentary requirements placed on both the purchaser and the vendor, with Ontario requiring the purchaser to provide the vendor with a form of "purchase exemption certificate" ("PEC").[67]

III - 2.2(b) *Inventory – Raw Materials, Work-in-Progress*

Technically, other inventory items, not for resale, are subject to PST. Fortunately, the *RSTA* contains some fairly broad exemptions for most raw materials intended to be incorporated into goods that will be resold. The most important of these exemptions is found in section 7(1)(41), which provides as follows:

> 41. Tangible personal property purchased for the purpose of being processed, fabricated or manufactured into, attached to, or incorporated into tangible personal property for the purpose of sale. However, this exemption does not apply with respect to,
>
> i. a returnable container for use or sale in Ontario, or
>
> ii. a computer program used to produce another computer program that may be purchased exempt from tax under paragraph 62.

III - 2.2(c) *Production Machinery & Equipment*

Ontario, PEI and most recently British Columbia are the only provinces that exempt production machinery and equipment from PST. The relevant exempting provision for Ontario is found in section 7(1)(40) of the *RSTA*, and is further defined by regulation. (See Figure 14).

The exemption is fortunate for many Ontario manufacturers, but is the subject of some very detailed and long-standing administrative policy, and jurisprudence. The end result is sometimes a PST assessment in respect of what everyone thought was simply "exempt P&M equipment" when the transaction took place.

Figure 14: ***Ontario Production & Machinery Exemption***

7.(1) **Exemptions** — The purchaser of the following classes of tangible personal property and taxable services is exempt from the tax imposed by section 2:

…

40. Such machinery, equipment or processing materials as may be prescribed by the Minister that are purchased to be used by a manufacturer or producer,
    i. directly in the manufacture or production of tangible personal property,
    ii. directly in and exclusively for research into or the development of goods to be manufactured or produced by any person,
    iii. directly in and exclusively for research into or the development of manufacturing or production processes for use by any person, or
    iv. directly in and exclusively for more than one of the purposes described in subparagraphs i, ii and iii,

    but not machinery, equipment or processing materials that are used by persons prescribed by the Minister or that are used in a manner, process, industry or enterprise prescribed by the Minister.

Note: The exemption dove-tails with section 14 of Regulation 1012. The exemption is also the subject to some very complex administrative policy.

III - 2.2(d) ***R & D Equipment***

Many manufacturing businesses use equipment for research and development ("R & D") purposes. The user of this equipment is generally seen as the ultimate consumer and is therefore required to pay tax on the equipment.

Ontario is the only province which provides a general exemption for machinery and equipment used in research and development. (See again Figure 14). As with the exemption for production and machinery equipment, there are a number of administrative issues involved in determining whether the "R&D" exemption will apply to certain equipment.

III - 2.2(e) ***Fixtures***

As alluded to above, the general rule in Ontario (and in the other PST provinces) is that "fixtures" – and other "real property" – are not subject to PST.

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". 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". Other examples might include contracts to install seats in sports arenas, elevators in buildings, storage tanks in factories, etc.

The word fixture means something which has become so attached to land as to form in law part of the land.[68]

Where TPP becomes attached to "real property" – which is somewhat like the manufacturing process, where TPP loses its identity as a separate item 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.

As such, under all PST systems, purchasers of real property or fixtures do not generally pay PST. There are, however, a couple of added complications.

First, Ontario has recently been taking a very narrow view of what is a fixture, attempting to assess PST on a whole host of real property contracts. Unfortunately, Ontario's approach may well be finding some support in recent Ontario judicial decisions. In the *Hydro* case (*supra*), for example, the Ontario Superior Court indicated that "the courts are more inclined to regard an item as a chattel if it is installed as part of its owner's business, as opposed to items installed to improve the freehold", and came to a conclusion that was unexpected by many PST practitioners. In contrast, case law in other provinces has proceeded more-or-less along conventional lines.[69]

Second, under jurisprudence first developed in the *Cairns Construction* case,[70] the "consumer" or "user" of the TPP in "real property" contracts is generally the person using it to fulfil the contract: in this case, the real property contractor. Accordingly, all PST systems have rules aimed at ensuring that such real property contractors self-assess and remit tax on the cost of the TPP they use in performing these real property contracts.[71]

III - 2.2(f) ***Computer Software***

Most provinces now tax computer software, and many related services.[72] With these changes, have come some fairly complex issues, as one attempts to understand how heretofore untaxed assets are taxed under the sometimes archaic provisions of Canada's provincial sales tax legislation. And in some instances, the answers are not intuitive, as is the conclusion when it comes to reselling any kind of software in a business transaction: it is generally subject to tax, even if you are selling what is *custom* software in your hands.

Some exemptions can apply, however, and Ontario, for example, has the following special exemption buried in Regulation 1012(14.2)(2)(f), exempting a resale of *custom* software, if sold in the following circumstances, if:

> used in a business [and] sold in a transaction in which the purchaser acquires all or substantially all of the business assets and will continue to carry on the business, and any modifications to the computer program provided to the purchaser.

Absent these sorts of circumstances, or other "creative" solutions, when a business sells its computer software to another business as part of an asset transfer, the computer software will generally be subject to PST.

This can obviously be a very unwelcomed piece of news, unless identified well before the fact.

Figure 15: ***Vendor Collection Obligations on Bulk Sales***

The vendor's obligation to collect PST arises under section 10 of the *RSTA*:

> 10. **Vendor to be Collector** — Every ~~vendor~~ is an agent of the Minister and as such shall levy and collect the taxes imposed by this Act upon the purchaser or consumer.

However, "vendor" is defined in section 1 as follows:

> "**vendor**" means a person who, ~~in the ordinary course of business~~,
> (a) sells or licenses tangible personal property,
> (b) sells or renders a taxable service,

III - 2.3 Sale Of A Business – Bulk Sales Issues

In Ontario, a "sale in bulk" is still generally taxable, on an asset-by-asset basis. Unlike the GST situation, there is no "rollover" provision – which can often result in layers and layers of PST applying as business assets are sold from one corporate entity, used for a period, and then sold again.[73] Some special considerations do arise, however.

III - 2.3(a) *Collection or Self-Assessment of the PST*

An interesting question arises on a sale of a business in Ontario. The question deals with the tax collection obligation on a "vendor" under section 10 of Ontario's *RSTA*, and the meaning of "vendor". (See Figure 15).

The issue is whether a "vendor" selling goods out of the ordinary course is really a "vendor" for purposes of the section 10 collection obligation.

While the purchaser would not be exonerated from paying the tax – presumably there would be a "self-assessment" liability on the purchaser. We understand that Ontario's Retail Sales Tax Branch is of the view that when a registered vendor disposes of its entire business by way of an asset sale, such a sale is not "in the ordinary course of business" and thus the vendor is not required to collect the PST. As such, the Branch considers that there is no collection obligation imposed on the vendor.[74]

While the aim of that policy might be to ensure that vendors *sans* assets are not given too much Ontario PST to carry around in their pockets, it is not entirely certain that the approach is legally correct.

III - 2.3(b) *Clearance Certificates*

Ontario, like a number of other jurisdictions, requires a vendor of bulk goods (e.g., a business) to obtain a clearance certificate certifying that "all taxes collectable or payable" by the vendor have been paid – or that other arrangements have been entered into, satisfactory to the Minister, for the payment of such taxes. (See Figure 16).

If the purchaser fails to obtain such a certificate from the vendor, then the purchaser is deemed to be responsible for the payment of any outstanding taxes that may have been collectable or payable by the vendor.

Accordingly, part of the "due diligence" involved in purchasing business assets in Ontario, whether or not in the context of a corporate reorganization, would generally require obtaining such a certificate, or some agreement as to how to deal with the consequences of not obtaining one.

Unfortunately, Ontario has been less-and-less willing to provide these certificates on a timely basis, even though there seems to be a statutory obligation to do so.

A failure to obtain a certificate, however, can have real consequences on a purchaser, as the purchasers of one Dominoes Pizza Franchise found out in the recent Dominoes Pizza case in PEI. There the PEI Supreme Court (Appeals Division) confirmed that when failing to obtain the clearance certificate, the purchase was indeed liable for the back-taxes of the vendor. Its seems, then, that is "purchaser beware" in these types of situations.

Figure 16: ***Ontario Clearance Certificate Requirement***

6.(1) **Sales in Bulk** — No person shall dispose of his, her or its stock through a sale in bulk to which the *Bulk Sales Act* applies without first obtaining a certificate in duplicate from the Minister that all taxes collectable or payable by such person have been paid or that such person has entered into an arrangement satisfactory to the Minister for the payment of such taxes or for securing their payment.

(2) **Idem** — Every person purchasing stock through a sale in bulk to which the *Bulk Sales Act* applies shall obtain from the person selling such stock the duplicate copy of the certificate furnished under subsection (1), and, if the person who is purchasing the stock fails to do so, that person is responsible for payment to the Minister of all taxes collectable or payable by the person who is disposing of the stock through a sale in bulk.

III - 2.4 Ontario's Rules for Related Party Transfers of Assets

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.[75] And the truthfulness of that comment can perhaps best be seen in the application of Ontario's rules.

While Ontario does have some special rules providing relief for related party transfers of assets, the rules are quite limited in scope.[76] Figure 17 sets out the basic rules, which are found buried in section 13 of Regulation 1013.

III - 2.4(a) *Common Ownership Requirement – 95 %*

Perhaps the first point to consider is that the relief only applies to very closely related parties, and generally in the corporate context, only where entities enjoy a common 95% ownership. That condition in itself will limit the everyday usefulness of the provision.

III - 2.4(b) *Difficult Pre-Conditions*

The second point to note is that application of the rules is predicated on two basic pre-conditions being precisely met:

(a) *No Prior Use of the Provision In Respect of Assets Transferred.* 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) *All Taxes Previously Paid.* The person wishing to benefit from the non-taxable treatment must be able to demonstrate that all PST ever imposed on any purchaser of the subject TPP has been paid at all times in the past.

Clearly, the pre-conditions are fairly daunting, and usually leave nothing but uncertainty in anyone's mind when attempting to assess whether the Ontario rules can be used in even the most common of situations.

Ontario further complicates the problems by insisting, from an administrative point of view, that before any exemption can be claimed, the purchaser must be able to establish that all PST has been previously paid, as applicable, and that no tax free transfers of the TPP have previously been made. Try doing some "due diligence" on those requirements!

The practical result is that there are very few "slam dunk" rollover situations in Ontario – at least when it comes to the PST side of things.

Figure 17: ***Ontario Related Party Transfer Provisions***

The following excerpts are from Ontario Regulation 1013.

1.1 In this Regulation,

"**wholly owns**", in respect of a corporation, refers to the beneficial ownership of not less than 95 per cent of the total issued and outstanding share capital of a corporation, exclusive of directors' qualifying shares. by a person, or by a person and one or more persons each of whom is a member of his or her family as defined in subsection 8(2) of the Act or his or her same-sex partner within the meaning of subsection 8(4) of the Act, and "wholly-owned" has a corresponding meaning.

TRANSFERS OF MERCHANDISE BETWEEN RELATED PERSONS

13 (2) This section does not apply to a transfer of tangible personal property if,

(a) the tangible personal property has been transferred at any previous time on a tax exempt basis under this section or any predecessor thereof; or

(b) any tax imposed by the Act on any purchaser who acquired the tangible personal property in any prior transfer or purchase has not been paid.

(3) No tax is payable by a corporation on its purchase of tangible personal property from a person who wholly owns, either directly or through another wholly-owned corporation, the purchasing corporation.

(4) No tax is payable by a person on the purchase of tangible personal property from a corporation that the person wholly owns, either directly or through another wholly-owned corporation.

(5) No tax is payable by a corporation on its purchase of tangible personal property from another corporation if both the selling and purchasing corporations are wholly-owned by the same person, either directly or through another wholly-owned corporation.

(6) No tax is payable by a person who purchases tangible personal property from a corporation the purchaser does not wholly own on that portion of the actual value of the tangible personal property equal to the proportion of the shares owned by the purchaser to the total issued and outstanding share capital of the corporation.

(7) No tax is payable by a corporation on its purchase of tangible personal property from a person who does not wholly own the corporation on that portion of the actual value of the tangible personal property not exceeding the actual value of any shares of the purchasing corporation issued to the person as part of the consideration, if the shares are retained by the person for a period of not less than six months after the purchase.

(8) For the purposes of subsection (7), a person shall be deemed to retain the shares if,

(a) the person subsequently transfers any of the shares for no consideration to a member of his or her family within the meaning of subsection 8(2) of the Act or his or her same-sex partner within the meaning of subsection 8(4) of the Act, who retains the shares until a date not less than six months after the date of the purchase referred to in subsection (7); or

(b) the person subsequently transfers the shares to a corporation in consideration for only shares of the corporation having an actual value at least equal to the transferred shares, and the person retains such new shares until a date not less than six months after the date of the purchase referred to in subsection (7).

III - 2.4(c) ***Narrow Scope Given to the Provisions***

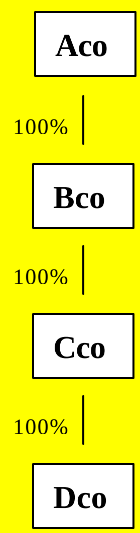
Even where these pre-conditions can be reasonably regarded as having been met, Ontario has been known to take a fairly narrow view on the application of the Regulation 1013(13) rules.

An example of the narrow approach taken, even where two companies are "wholly owned", is that Ontario only 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. This means that difficulties can arise in multi-tiered structures. (See Figure 18).

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

Figure 18: ***Regulation 1013(13) & Multi-Tiered Structuring***

Consider the following situation:



Assume A "wholly owns" B, B "wholly owns" C, C "wholly owns" D.

If all other pre-conditions are met, Ontario will clearly allow A, B, and C to buy from or sell to each other on a non-taxable. That simply follows from an application of various of the rules in Regulation 1013(13).

On the other hand, in no circumstances would Ontario allow A or D be buy from or sell to or from each other on a non-taxable basis under these rules.

The example thus demonstrates the inherent inflexibility of the Regulation 1013(13) rules.

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

III - 2.4(d) ***Current Review of Regulation 1013***

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. Unfortunately, not much has happened on this front within the last 6 years, and what changes are in store, if any, are being kept secret. Our 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.

Perhaps the practical answer is that the Retail Sales Tax Branch has been busy with other things – including its recent consultations on the taxation of computer software, and related IT services.

III - 2.5 **Administrative Treatment Afforded Common Corporate Reorganizations**

Given the limited nature of the regulatory exemptions for related party transactions, Ontario does administratively allow for the following treatments of common corporate reorganizations.

III - 2.5(a) ***Amalgamations***

Amalgamations are authorized by statute (e.g., the *Canada Business Corporations Act (Canada)* or the Ontario *Business Corporations Act*), and usually only involve the exchange of shares (IPP).

Since no TPP is usually transferred, amalgamations are usually not subject to PST.

III - 2.5(b) ***Winding Up***

The transfer of title to or possession of TPP from a corporation to any shareholder as the result of the winding up or dissolution of the corporation is generally considered to be a taxable sale. The most important exception is where the corporation has held the asset "tax paid" – based on its consumption of use of the asset – in which case a sale is not considered to occur.

Where the TPP subject to the winding up is "exempt" TPP under the *RSTA*, another special exception ensures that no taxable sale is considered to occur. A similar treatment exists where the shareholder can demonstrate that it is acquiring the TPP for resale.

III - 2.5(c) ***Sales Between Unrelated Parties (Purchaser Being a Corporation)***

Where the vendor and purchaser do not meet the rather narrow exemption for related parties, subsection 13(7) of Regulation 1013 can provide for the exempt transfer of assets if the vendor takes back shares from the purchaser in the following situation:

- the transferred assets have already been taxed on a previous transfer;
- the vendor receives shares equal to the value of the assets; and
- the vendor holds the shares for at least *6 months*.

To the extent that non-share consideration (or "boot") is received, PST would be payable on these amounts.

III - 2.5(d) ***Partnerships***

A discussion of partnerships is beyond the scope of this paper. Suffice it to say that the *RSTA* does not address the PST implications of partnership transactions. Ontario does have some administrative policy on the subject, and takes the view that where two or more persons join together to form a new partnership, any TPP transferred into the new partnership will not attract tax if the participating partners have paid tax, before the transfer, on their acquisition of the TPP.[77]

Where new partners join existing partnerships, Ontario considers that to be a formation of a new partnership, and allows TPP to be transferred in if tax has previously been paid by the existing partners, the existing partnership or the new partners on their initial acquisition of the TPP.[78]

Ontario has other more detailed administrative policy on partnerships, and changes to Regulation 1013(13) may also be forthcoming to deal with partnerships in a regulatory context.

The application of RST on transfers of Limited Partnership interests also remains an unilluminated and quite difficult area.

ENDNOTES:

1 For non-resident readers, the Canadian concept of "commodity taxes" is similar, in some respects, to the American concept of "sales and use" taxes. The Canadian concept of "commodity taxes" does, however, capture more than just "sales and use taxes", and includes the federal GST/HST, which is a value-added tax, the provincial retail sales taxes, and taxes and duties imposed under Canada's customs and international trade regimes (e.g., tariff classification, origin, valuation, anti-dumping and countervailing, and WTO issues). Commodity taxes can also be seen to capture a whole host of other federal and provincial excise duties and taxes (e.g., like those imposed on motor fuels, tobacco and liquor).

For the most part, only the federal GST/HST and the provincial sales taxes will be relevant for corporate reorganizations. The focus of this paper will be on the application of the GST/HST, and the Ontario provincial retail sales tax ("PST") on corporate reorganizations.

2 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.

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

4 See section 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.

5 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.

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*.

6 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.

7 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.

8 A recipient is defined in section 123(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.

9 "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 section 123(1) of the *ETA*.

10 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.

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

12 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.

13 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).

14 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*).

15 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.

16 In the GST context, the CCRA 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).

17 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.

18 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.

19 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 sections 123(1), 148 and 148.1 of the *ETA*.

20 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".

21 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.

22 The CCRA'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.

23 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".

24 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%.

25 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".

26 Typical acquisition costs could include, for example, legal and accounting fees for services used in connection with the set-up or structuring of the share transaction, and in more complex transactions, costs

incurred for the corporate finance work required on the matter, and costs incurred by holding companies or other special purpose vehicles, and costs associated with take-over bids.

27 This follows directly from the definition of "commercial activities", which deems "exempt activities" like the provision of financial services to be something other than "commercial activities":

> "commercial activity" of a person means
>
> (a) a business carried on by the person (other than a business carried on without a reasonable expectation of profit by an individual, a personal trust or a partnership, all of the members of which are individuals), *except to the extent to which the business involves the making of exempt supplies by the person*,
>
> (b) an adventure or concern of the person in the nature of trade (other than an adventure or concern engaged in without a reasonable expectation of profit by an individual, a personal trust or a partnership, all of the members of which are individuals), *except to the extent to which the adventure or concern involves the making of exempt supplies by the person*, and
>
> (c) the making of a supply (*other than an exempt supply*) by the person of real property of the person, including anything done by the person in the course of or in connection with the making of the supply;

28 Equally noteworthy is that even if engaged only in minimal commercial activities (e.g., selling pencils), a person might not be mandatorily required to be registered. The reason lies in the "small supplier" exception in section 240(1)(a), and effectively means that a person is required to have in excess of $30,000 of aggregate taxable supplies in any of the preceding 4 quarters before the registration requirement kicks in. See again note 18.

29 See again note 9. A "registrant" is defined to be a person "who is registered, or who is required to be registered" for purposes of the GST.

30 Note that while selling a few pencils will create the necessary level of commercial activities for one to voluntarily register for the GST, it will not guarantee that ITCs are available for unrelated financial activities, like acquiring, holding and/or selling shares.

31 The acquisition period begins when the goods or services were acquired and concludes on the later of: (i) the day all or substantially all of the shares were acquired; and (ii) the day the take-over bid was abandoned.

32 That effectively precludes ITCs for take-overs of financial institutional, and other "exempt" businesses.

33 See GST Memorandum 700-5-6 (*Input Tax Credits For Holding Companies, Takeovers, And Multi-Tiered Corporations*, December 9, 1991).

34 The corporations must be related at the time of acquisition, it is insufficient to only be "related" after the acquisition (see GST/HST Policy Statement P- 137). This raises the essential question of "when is a service acquired?"

35 Further information may be obtained from GST Policy P-137 P-137 (*Availability of ITCS to Holding Corporations on Cost of Acquisition*, May 16, 1994).

36 See GST Policy P-196 (*Whether Administrative Overhead Costs Fall Under Subsection 186(1) Of The Excise Tax Act*, January 4, 1996).

37 See the CCRA's response to Question 39 posed at the Canadian Bar Association - Sales and Commodity Tax Section's February 25, 1999 Annual Meeting.

38 See the CCRA's Question and Answer Database GST #7 (April 1991)

39 See *BJ Services Company Canada v. The Queen* (2002), 2003 GTC 513 (TCC)

40 See GST Ruling 11585-12 (December 13, 2000)

41 *3859681 Canada Inc. and Zellers Inc. v. Her Majesty the Queen*, [2003] G.S.T.C. 123 (TCC) (GST)I.

42 See section 298 of the *ETA*.

43 The assumption is that the assets are being acquired domestically. While some "place of supply" issues might arise with the cross-border movement of business assets, in a number of instances the "place of supply" will still be Canada (e.g., if goods are being purchased, and the goods are either delivered or made available to the non-resident purchaser in Canada; if intangibles are being purchased, the property will be used in whole or in part in Canada).

44 For a detailed discussion of the GST implications of purchasing and selling a business, as well as the analysis underlying Figure 8, please see W. Jack Millar & Robert G. Kreklewetz, *Purchase & Sale of a Business*, (November 9, 1994) Seminar Materials presented at the CCH 1994 GST Update (Toronto, Ontario).

45 Capital property is generally depreciable property under the *Income Tax Act*, but would not include Class 12, 14 or 44 assets. "Real property" is defined in section 123(1) of the *ETA*. Section 136(1) of the *ETA* deems a supply by way of lease, licence or other right to use real property to be a supply of "real property".

46 The obvious reason for this exception is the concern that without it, the GST would be otherwise paid to and collected by the non-resident vendor, possibly leaving Canada with some difficulty in persuading the non-resident to remit the GST back to the government.

47 The second exception is aimed, much like the section 167 election (below), at relieving the purchaser from having to pay GST in situations where the purchaser will likely be able to apply for and receive a full ITC at a later date.

48 Note that subsection 228(4)(b) is also applicable in situations where subsection 221(2)(a) applies because the vendor is a non-resident, or is only a non-resident because of the "permanent establishment" deeming rule.

49 See section 231. While a full discussion of how these rules work is outside the scope of this paper, the general rule is that a person who makes a taxable supply to an arm's-length person, and who remits that tax as required, is able to claim a special ITC if a bad debt results. A special formula is used, and the product is generally equal to 7 / 107ths of the amount written off.

50 For example, "goodwill" could be read quite narrowly, and confined to what is conventionally considered goodwill. On the other hand, it could also be given a broader interpretation, so as to include such things as customer databases, key intellectual property rights, preferential leasing arrangements, franchise rights and so on (all of which give the business added competitive advantage and arguably contribute to the value of a business's "goodwill".

51 See GST/HST Policy Statement P-242, July 15, 2003.

52 While relief under section 167 is generally available irrespective of the parties' GST registration status, it is specifically *not available* where the vendor is a GST registrant but the purchaser is not a registrant.

53 See *Ruhl v. Canada*, (1998) G.S.T.C. 4 (TCC). In that case, the Court held that using a vehicle 80% of the time for purposes of gaining income qualified for the "substantially all" standard required for claiming full ITCs. See also *Wood*, (1987) C.T.C. 2391 (TCC), and *Noseworthy*, (1996) 2 C.T.C. 2006 (TCC), where the Courts noted

that "substantially all" is not capable of a "simple mechanical formula". Other cases adopting an 80% threshold include *Eberle v. Canada* [2001] D.T.C. 158 and *Mckay v. Canada* [2000] G.S.T.C. 93.

54 See Question 12 of the CCRA and Canadian Bar Association (Sales and Commodity Tax Section), Annual Meeting, February 27, 2003. For commentary see: Robert G. Kreklewetz, "2003 CBA-CCRA Roundtable Discussion", *GST & Commodity Tax*, Vol. XVII No. 6, p.41.

55 For a good analysis of section 167 relief, see Millar & Kreklewetz, *supra* note 39, and W. Jack Millar and Brent F. Murray, *GST/HST & PST Issues Associated with Buying & Selling a Business*, (May 30, 2000) Seminar Materials Presented at the CBA's Tax Law for Lawyers Conference (Niagara-On-The-Lake, Ontario).

56 See Question 10 of the CCRA and Canadian Bar Association (Sales and Commodity Tax Section), Annual Meeting, February 27, 2003.

57 For example, assuming both parties are monthly GST filers (monthly reporting periods) and that the sale occurs on May 15th, the purchaser will pay the "consideration for the supply" on May 15th, but will not pay the GST until June 30th (the last day in which the vendor is required to file its return and remit the net tax). The purchaser then files its return sometime in June, and since subsection 229(3) requires the CCRA to pay interest twenty-one days after the return is filed, the purchaser should ensure that it files its return on or before June 9th (21 days prior to months end). In this scenario, the purchaser may suffer cash flow consequences (paying tax on June 30th), but it will be paid interest "beginning on the day that is twenty-one days after" the date the return was filed (i.e., if filed on June 9th, interest begins accruing on June 30th).

58 While there are no longer any filing requirements, form GST 25, *Election for Nil Consideration,* must be kept on file.

59 Note that the GST payable under section 165 of the *ETA* (i.e., the charging provision for Division II tax) is payable only on "the value of the consideration for the supply". The effect of the deeming rule in section 156 is, therefore, to make all supplies between the particular corporations free of GST (not technically "exempt" or "zero-rated", just free of the GST).

60 Section 150 provides a similar election for closely related members of a group that includes a "listed financial institution".

61 While this may seem like an overly technical approach to these elections, the approach is mandated because of the CCRA's seemingly mono-focused view of how these elections work: without full compliance with all of the technical requirements, the CCRA views the requirements for the elections as not met, and the "exemptive" nature of the elections as inapplicable.

62 Other deductions and limitations exist. Please consider section 325. Recent amendments have ensured that only the net amount assessed against the transferee under section 160(2) of the *Income Tax Act*, in excess of amounts paid by the transferor, is deducted in determining the liability under section 325 of the *ETA*.

63 See the *Amalgamations and Windings-Up Continuation (GST) Regulations.*

64 See sections 2(6) and 10 of the *RSTA*.

65 In PST lingo, "non-taxable" is something that is never taxed in the first place. Something that is "exempt" is something that first falls under the umbrella of the *RSTA*'s taxing provisions, but for which there is an express exemption in the *RSTA*.

66 This follows from the constitutional limitations imposed on the provinces by s. 92(2) of the *Constitution Act, 1867* – formerly the *British North American Act.* Constitutionally, provinces were only able to levy "Direct Taxation within the Province in order to the raising of the Revenue for Provincial Purposes". "Direct

taxation" is generally accepted as a tax imposed on the person who will ultimately bear it, and is set out by the economist John Stuart Mill's as follows:

> Taxes are either direct or indirect. A direct tax is one which is demanded from the very persons who, it is intended or desired, should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another: such as the excise or customs ... Direct taxes are either on income or on expenditure ...

Since a tax on a person intending to re-sell a good would generally be passed on to the subsequent purchaser, there is a constitutional imperative for ensuring that goods purchased for resale are not subject to tax.

67 Although there is no prescribed form, an example of the exemption certificate required in Ontario is provided in Ontario Related Sales Tax Guide No. 204. The certificate's requirements include: i) the purchaser's vendor permit number (if applicable); ii) the signature of the purchaser; iii) the business name of the purchaser and; iv) a statement claiming the basis for the exemption.

68 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).

69 See *Westshore Terminals v. The Queen,* [1999] E.T.C. 5012 (B.C.S.C.), holding that overhead cranes used at a coal shipping terminal to be fixtures; and *Deloitte & Touche v. 1035839 Ontario Inc.* (1996) O.R. (3d) 139, holding that the contents of a bleach plant all to be fixtures.

70 See, for example, *Cairns Construction Ltd. v. Government of Saskatchewan,* [1960] S.C.R. 619.

71 In the case of non-resident contractors, some systems, like that in Ontario, impose a further twist: imposing "hold-back" type requirements on Canadian residents contracting with non-resident contractors. In Ontario, for example, section 39(3) requires non-resident's entering into real property contracts to deposit with the Minister 4% of the contract price, on account of its tax obligations, and to provide the Ontario purchaser with a certificate indicating it has done so. If the Ontario purchaser begins "dealing with a non-resident contractor without first obtaining" the certificate, section 39(4) requires the purchaser to deduct 4% from all amounts payable, and remit it to Ontario. Where that is not done, the purchaser is deemed to be "personally liable" for those amounts.

72 Ontario, for example, recently enacted Bill 198, with the effect of expressly taxing the following computer related services, as "taxable services" for purposes of section 1(1) of the *RSTA*:

> (c.1) labour provided to install, configure, modify or upgrade a computer program, as those words are defined by the Minister, where there is a sale of the labour on or after July 19, 2002.
>
> …
>
> (d.1) any contract entered into on or after July 19, 2002 for the service, maintenance or warranty of a computer program, as those expressions are defined by the Minister … .:

New exempting paragraph 7 (1)(2.0.1) provides exemptions for these new "taxable services":

> i. that are provided in respect of a computer program that may be purchased exempt from tax under paragraph 62, or
>
> ii. that are provided by a person for the person's own consumption or use.

73 Note that the intermediate use of the assets would preclude taking the position that the assets were "purchased for resale".

74 In this situation, the Branch considers that it is the purchaser who is responsible for remitting the tax applicable on the sale. Given this view, purchasers should be wary of remitting the tax directly to the vendor as, where the vendor fails to remit the tax, the Minister may still assess the purchaser for the unpaid tax.

75 While the lack of symmetry may be surprising, the answer may lie in the fact that the Ontario regulations prescribing the related party transfers have been in place, in more-or-less the same form since 1964 – a time when section 85 rollovers did not exist, and would have been largely irrelevant, given the pre-1972 structure of the Canadian *Income Tax Act.* Ontario, then, has simply failed to move with the times.

76 In this last sentence, the word “limited” cannot be over-emphasized.

77 See Ontario Sales Tax Guide No. 210 “Partnerships”, March 2001.

78 *Ibid.*