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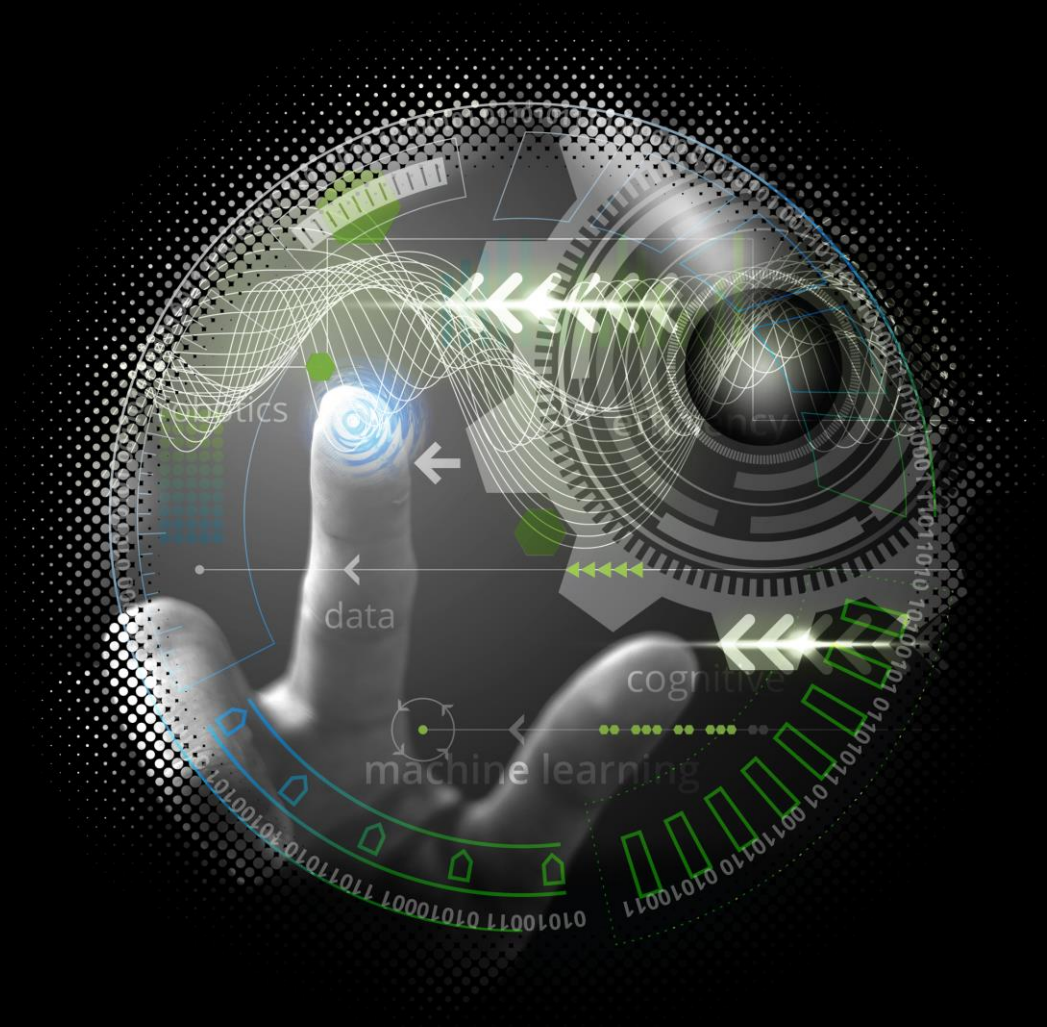

CPA Commodity Tax Symposium

Claim me if you can – Financial Institutions and ITCs

Simon Douville and Danny Cisterna | Deloitte LLP | October 23, 2019

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Section 141.02 – pre-approval process 11 years later

Framing the issue

- MNR (CRA) has enormous powers (see for example 141.02(20), (23), (32))
- Depth and breadth of scope of section 141.02 - does it override sections 169 and 141.01?
  - Can the MNR deny an application for pre-approval if the MNR believes an entitlement to an ITC does not exist in the first instance?
  - Or is the MNR's power to deny limited to ITC allocation methodologies that are not "fair and reasonable"?
- What are the redress remedies if application is denied because of:
  - An entitlement dispute?
  - A disagreement on whether the ITC allocation methodology(ies) is(are) not "fair and reasonable"?

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Section 141.02 – pre-approval process 11 years later

Background

- Apply to all FIs in respect of the requirement to apportion the use of inputs between taxable and exempt activities
- Inputs must be bucketed

Input classification	141.02 ITC allocation rules
Excluded – generally capital property inputs	• Use "specified method" or own method if no specified method exists
Exclusive – other than **excluded** inputs 100% allocable to the making of taxable supplies for consideration or 100% allocable to other than the making of taxable supplies for consideration	• 100% recoverable or 0% recoverable
Direct – other than **exclusive**, **excluded** and **non-attributable**	• Use "direct attribution method" or own method if no direct attribution method exists
Non-attributable – other than **exclusive** or **excluded** and that are not attributable to the making of any particular supply	• Use "specified method" or own method if no specified method exists
Residual – total of **direct** and **non-attributable**	• Impacts QIs • Use own method as pre-approved by the MNR • Or relegated to use prescribed rate

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Section 141.02 – pre-approval process 11 years later
Background

- Who is a "qualifying institution" ("QI")?

	ITCs on residual inputs for each of the last 2 years is equal to or greater than:	
QI	Prescribed amount	Prescribed rate
Insurer	$500,000	10%
Bank	$500,000	12%
Securities dealer	$500,000	15%

- QIs can ask for pre-approval for their ITC allocation methodologies, otherwise relegated to prescribed rate or less for ***residual*** inputs
- If relegated to prescribed rates for residual inputs, use "normal" rules in 141.02 for ***excluded*** and ***exclusive*** inputs

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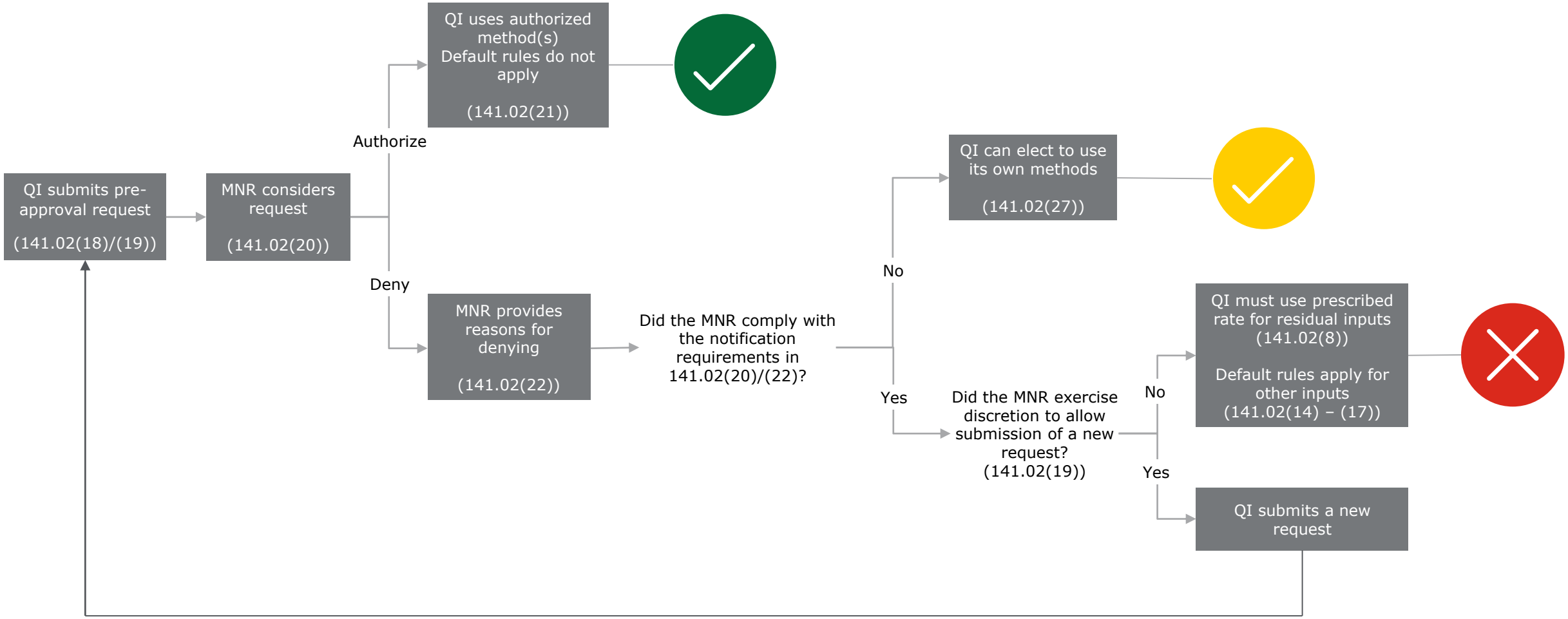
Section 141.02 – pre-approval process 11 years later

Roadmap to pre-approval



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Section 141.02 – pre-approval process 11 years later

Next steps/redress remedies

QI uses authorized method(s)
Default rules do not apply
(141.02(21))

- All good – upon audit, methodologies should not be open to question
- Numbers used in methodologies subject to audit scrutiny/adjustment

QI can elect to use its own methods
(141.02(27))

- Upon audit, CRA can assess if they believe methods are not fair and reasonable
- QI can object and argue matter at Appeals and/or Tax Court
- Query whether this will ever be an option – to be discussed

QI must use prescribed rate for residual inputs (141.02(8))

Default rules apply for other inputs
(141.02(14) – (17))

- Appears to be no remedy to Appeal or go to Tax Court
- Can consider applying for a Judicial Review at Federal Court
  - Did the MNR not follow the process where the QI's methods are fair and reasonable?
  - Can the MNR deny where he/she believes no ITC entitlement exists in the first instance?

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Section 141.02 – pre-approval process 11 years later

Does 141.02(27) work?

- If all conditions ***not*** met, then only remedy appears to be a Judicial Review application to Federal Court
- Issue is with condition (d) – when will this ever happen?
- Not consistent with wording in Finance Backgrounder from Sept. 23, 2009

> ***(27) Qualifying institution's own methods*** *— Despite subsections (6), (8), (14) and (15), a qualifying institution for a fiscal year may elect to use particular methods for the fiscal year to determine, for the purposes of this Part, the operative extent and the procurative extent of every business input of the qualifying institution, if*
>
> *(a) the particular methods were specified in an application filed under subsection (18) by the qualifying institution for the fiscal year that*
>
> *(i) complies with the requirements set out in subsection (19), and*
>
> *(ii) is the last such application filed by the qualifying institution for the fiscal year;*
>
> *(b) the use of the particular methods was not authorized by the Minister under paragraph (20)(a);*
>
> *(c) the qualifying institution has provided all requested information within the time set out in the written notice requesting the information;*
>
> ***(d) the Minister has not complied with the notification requirements set out in paragraph (20)(b) and subsection (22) in respect of the application****; and*
>
> *(e) if the Minister has provided modifications in writing to the particular methods on or before the particular day described in subsection (22), the particular methods with those modifications (in this section referred to as the "modified methods") are not fair and reasonable for the purpose of determining the operative extent and the procurative extent of the business inputs of the qualifying institution for the fiscal year*

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Section 141.02 – pre-approval process 11 years later

What does it deal with?

- Per Finance, section 141.02 exists to "…provide greater clarity and direction to all FIs respecting which ITC allocation methods they can use" plus the requirement for a QI "…to use a prescribed percentage or to obtain pre-approval of the Canada Revenue Agency (CRA) to use their own ITC allocation"
  - Essentially provides real time scrutiny on QIs
  - For other FIs, generally not that different from before 141.02 existed
- It modifies 141.01(5) which deals with the general guidance applicable to ***all*** registrants that any ITC allocation methodology must be ***"fair and reasonable"***
  - 141.01(5) is ***"subject to"*** 141.02 – so 141.01(5) is conditional or dependent on the rules in 141.02, but still has application
  - 141.02 only applies to financial institutions
- Underpinning the rules in 141.02 quite clearly is that any ITC allocation methodology used, whether directed by the MNR or is the FI's own methods, it must meet the general condition of being ***"fair and reasonable"***
  - 14 references to ***"fair and reasonable"*** in 141.02 – e.g., 141.02(7), (16), (27), (28), (30), (31), (32) and (33)
  - Important for redress considerations

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Section 141.02 – pre-approval process 11 years later

What does it ***not*** deal with?

- 141.02 does ***not*** deal with the ***entitlement*** to an ITC as determined under section 169 and further modified by section 141.01
  - i.e., it does not override sections 169 and 141.01
- Support for this position
  - None of sections 169, 141.01 or 141.02 uses language that would override the other sections, such as "notwithstanding section…" or "despite section…"
  - Subsection 141.01(5) is "subject to" section 141.02, which effectively means one must look to the rules in 141.02 when applying subsection 141.01(5)
  - Finance's Backgrounders' comments
  - CRA's own publications – e.g., see TIB-106 and RITS 167875 (September 26, 2018)
  - Scheme of the ETA
- Matters of ***entitlement*** should be dealt with at audit and allow for normal redress procedures to apply (i.e., Appeals, Tax Court, etc.)
  - The CRA and QI should both have their "day in court" to address an entitlement issue

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Section 141.02 – pre-approval process 11 years later

Example entitlement matter – foreign interchange related to credit card usage

Facts

- QI bank is a credit card issuer and earns interchange fees from non-resident acquirers when cardholders use their credit cards generally with merchants located outside Canada
- The interchange fees form a significant portion of the revenue earned by the QI in running its credit card business and thus are used and relied upon to cover the costs of running that business
- The QI is of the view that the interchange fees earned from the non-resident acquirers represent consideration for making zero-rated supplies of financial services and thus it is entitled to claim ITCs on the portion of the input costs related to operating its credit card business that is attributable to the earning of the zero-rated interchange fees
- This entitlement is reflected in its application for pre-approval of its ITC allocation methodology filed with the MNR pursuant to ss. 141.02(18)
- CRA does not agree that the interchange fees earned from non-resident acquirers are in respect of zero-rated supplies of financial services (i.e., CRA believes that they are in respect of exempt supplies) and thus believes that no ITCs are available related to those revenues earned

Issue

- Does section 141.02 give the MNR the power to deny the QI's ITC allocation methodology simply because it believes that there is no commercial activity with respect to the interchange fees?

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Section 141.02 – pre-approval process 11 years later

Example entitlement matter – foreign interchange related to credit card usage

Response and considerations

- Answer should be ***no*** – without addressing whether CRA or the QI is correct in its interpretation, this is an entitlement question that may be reassessed by CRA at the time of audit and for which, the QI is entitled to object and let CRA Appeals or the courts decide
- On the matter of how inputs are allocated to the earning of the alleged zero-rated interchange fees, the MNR does have the power under section 141.02 to deny the ITC allocation methodology if it believes the method proposed by the QI is not fair and reasonable

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Section 141.02 – pre-approval process 11 years later

Example entitlement matter – management and administration of segregated funds by an insurer

Facts

- QI insurer promotes and sells insurance policies as investment products under the banner of segregated funds from which it earns management fees as consideration for the management and administration of investments made by the segregated funds and any payments from and to/redemptions made by policyholders
- The management fees are integral to the payment of the QIs costs of running the segregated fund business, including as it relates to selling, promoting, managing and administrating the policies/segregated funds
- All fees earned by the QI in relation to the promotion, selling, management and administration of the policies/segregated funds are taxable in accordance with section 131 of the ETA
- In its application for pre-approval of its ITC allocation methodology filed with the MNR pursuant to ss. 141.02(18), the QI intends on claiming 100% ITCs on those costs on the basis that they were consumed/used solely to earn the taxable fees, citing section 169 as support in doing so
- CRA is of the view that the QI would not be entitled to claim ITCs on certain of the inputs (i.e., those related to promoting, selling etc. of the insurance policies) as these inputs are consumed or used in providing an exempt financial service – i.e., selling of the segregated fund policies - CRA's view is based on its first-order supply policy

Issue

- Does section 141.02 give the MNR the power to deny the QI's ITC allocation methodology simply because it believes that the inputs in question are not consumed or used in earning the taxable management/administration fees by the QI pursuant to section 169?

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Section 141.02 – pre-approval process 11 years later

Example entitlement matter – management and administration of segregated funds by an insurer

Response and considerations

- Answer should be ***no*** - without addressing whether CRA's position is correct or not, this is a question that should be decided upon an audit assessment of the QI's return and the normal appeal remedies that follow from that assessment
- CRA's position here relates to whether the QI is ***entitled*** to claim the ITCs (pursuant to section 169) in the first instance on those disputed costs rather than whether the methodology by which the QI determines the extent by which it is entitled to claim ITCs is fair and reasonable

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Section 141.02 – pre-approval process 10 years later

Where are we today?

- More scrutiny today by CRA compared to early years of the rules
- Better understanding as to how the rules work
- MNR has enormous powers (see for example 141.02(20), (23), (32))
- Is the pre-approval approach under the current rules working?
  - MNR powers should not extend to ***entitlement*** issues – 141.02 does not override sections 169 and 141.01
  - Is there a flaw in subsection 141.01(27)? Affects redress process – Judicial Review vs. "normal"

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ILPs and ITCs

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ILPs and ITCs

ITCs available to ILPs as LFIs

Before January 1, 2019

- GST/HST generally not recoverable by ILPs, unless they had any commercial activities.
- ILPs did not qualify as “investment plans”. Therefore, they would not be LFIs.
- Where some limited partnerships may have been LFIs, they likely had only one Permanent Establishment (PE) (i.e., PE of GP) and thus were not SLFIs.
- Prior to September 7, 2017, in the proper facts and circumstances GST/HST may not have been payable on the compensation paid to a GP for their management and administrative duties.

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ILPs and ITCs

ITCs available to ILPs as LFIs

After January 1, 2019

- Addition of paragraph (f.1) to subsection 149(1) – ILPs are treated as "investment plans".
- As a result, ILPs became LFIs under subparagraph 149(1)(a)(ix)
- ILPs may also be SLFIs
  - ILPs that are SLFIs are treated as "distributed investment plans" (DIP) for purposes of determining their liability for the provincial portion of the HST (PVAT) under the Special Attribution Method (SAM)
  - An ILP will be deemed to have a Permanent Establishment (PE) in a province where:
    - The ILP is qualified, under the laws of Canada or a province, to sell or distribute units, or
    - A person resident in the province holds one or more units of the ILP.
- ILPs that elected to become LFIs before January 1, 2019 should have been able to benefit from claiming ITCs as of that time.

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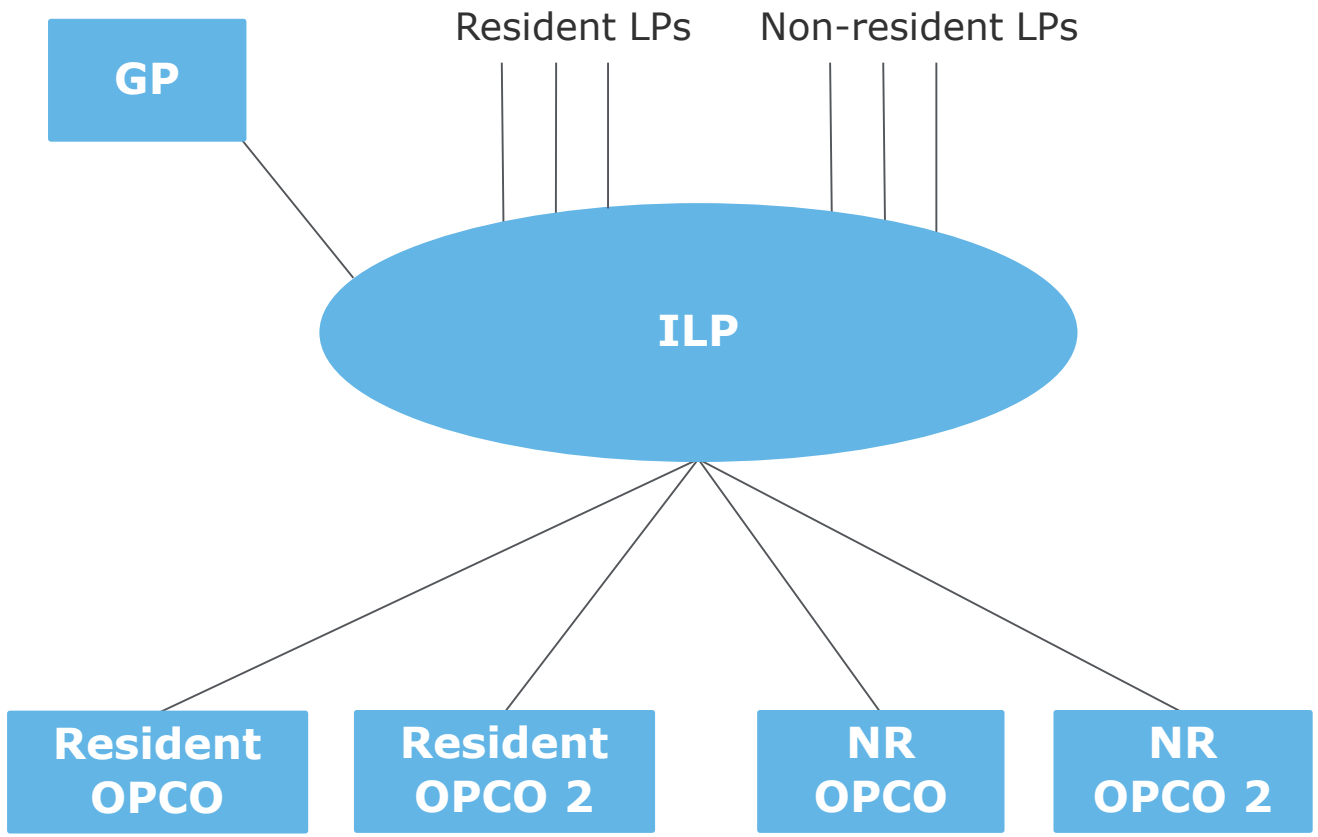
ILPs and ITCs
Zero-rated supplies

Structure



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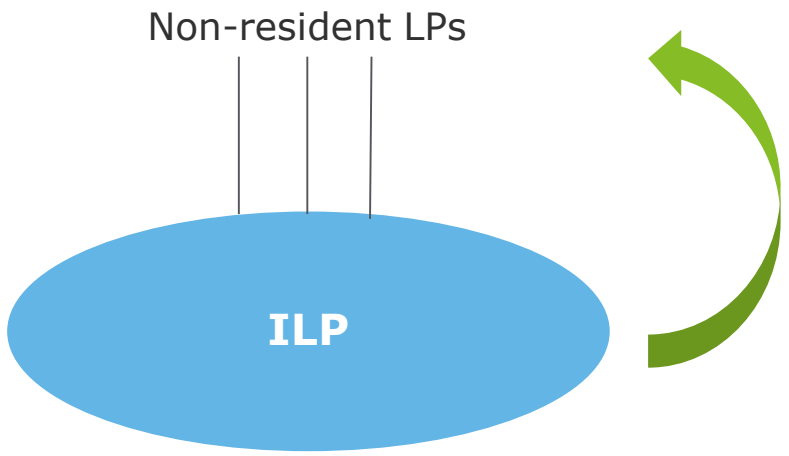
ILPs and ITCs
Zero-rated supplies

Considerations

- As LFIs, ILPs may now be entitled to claim ITCs by virtue of making zero-rated supplies of financial services to non-resident persons, including its non-resident investors (i.e., limited partners of the ILP) and its non-resident investees.
- Financial services may be zero-rated under sections 1 to 3 of Part IX of Schedule VI.



Example of financial services supplied to investors include:

- Issuing/redeeming partnership units;
- Receiving monies relating to capital calls;
- Payment of monies as distributions relating to the partnership units; and
- Management/administration of partners' partnership accounts.

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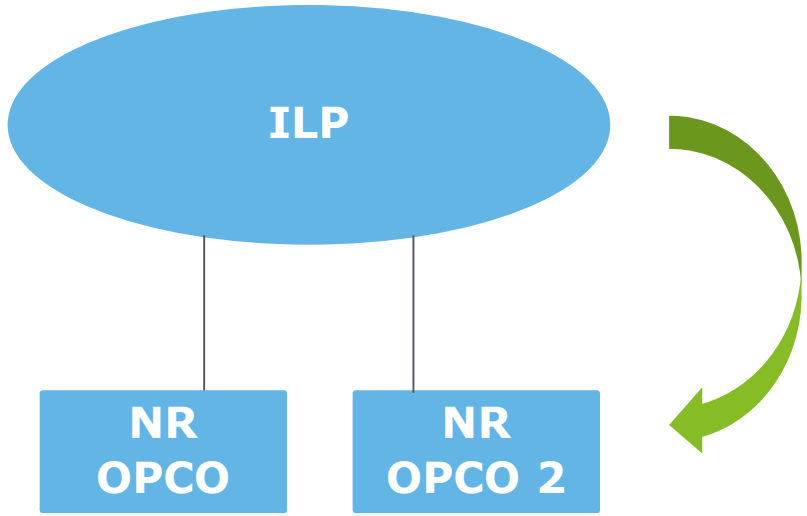
ILPs and ITCs
Zero-rated supplies



Example of financial services supplied to investees include:

- Purchasing/redeeming/holding financial instruments such as corporate shares or partnership/trust units;
- Receiving monies as dividends/distributions in respect of such shares/units; and
- Lending monies to investees, including receiving monies as principal and/or interest in respect of such lending.

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ILPs and ITCs
Section 225.4

Considerations

- ILPs that are SLFIs need to consider the application of subsections 225.4(3) or (4).
- Election available under subsections 225.4(6) or (7) so that subsections 225.4(3) or (4) does not apply.
- Cost/benefit analysis required to determine whether the ILP is better off claiming ITCs versus foregoing ITCs and including non-resident persons in the PAP calculation.

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ILPs and ITCs
Section 225.4

No election – default rule

- Deems units held by individuals or specified investors that the ILP knows on December 31 are not resident in Canada to be held by a particular individual that is resident in Canada, but not resident in a participating province.
  - Results: Lower Provincial Attribution Percentage (PAP), which will result in lower PVAT liability under SAM.
- Deems any supply made to a person that is not resident in Canada to have been made to a person resident in Canada.
  - Results: No ITCs available for inputs used in making supplies to non-resident investors.
- ITCs remain available in respect of "exclusive inputs" used to make zero-rated supplies other than zero-rated supplies to non-resident investors.
  - Results: ILP can still claim ITCs with respect to exclusive inputs used to make zero-rated supplies to non-resident investees.

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ILPs and ITCs
Section 225.4

Election

- Units held by individuals or specified investors that the ILP knows on December 31 are not resident in Canada are treated as being held by a non-resident of Canada.
  - Results: Higher PAP, which will result in a higher PVAT liability.
- Any supply made to a non-resident investor is considered to have been made to a non-resident person
  - Results: ITCs available for inputs used in making supplies in respect of units held by non-resident investors.
- ITCs available for all inputs related to all zero-rated supplies made to non-resident investors and/or investees.

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ILPs and ITCs
Section 225.4

Example

- ILP is resident in Albert and incurs $1,000 of GST (5%).
- The investors are as follows:
  - 10% are resident in Alberta
  - 10% are resident in Ontario
  - 80% are non-resident of Canada
- All investments are Canadian (i.e., no non-resident investee)
- ILP's cost are applicable 50/50 as to NR partners and NR investments.

Outcome

Election	On PAP	PVAT	ITC Rate	Net GST + PVAT
ILP does not elect (NRs included in PAP base)	0.8% (10% x 8%)	$160 [($1,000 - $0) x 10% x (8%/5%)]	0%	$1,160 [$1,000 + $160]
ILP elects (NR excluded from PAP base)	4% (50% x 8%)	$480 [($1,000 - $400) x 50% x (8%/5%)]	40% [(50% x 0%) + (50% x 80%)]	$1,080 [$600 + $480]

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ILPs and ITCs
Section 186 – Proposed changes

- On May 17, 2019, the Department of Finance released Draft Legislation Relating to the Excise Tax Act and Explanatory Notes. Among the different amendments proposed, it is proposed to extend the application of subsection 186(1) to holding partnerships and holding trusts.
- ILPs can now claim ITCs under the right facts and circumstances with respect to its holdings of operating corporations.

Conditions:

(1) ILP must be resident in Canada;

(2) ILP must be a registrant, and

(3) The underlying corporation must be an "operating corporation" within the meaning of the term.

> "An operating corporation of a partnership would be a corporation that is engaged exclusively in commercial activities and that is controlled by
>
> (i) the partnership,
>
> (ii) a corporation that is controlled by the partnership,
>
> (iii) a corporation that is related to a corporation referred to in subparagraph (ii), or
>
> (iv) a combination of persons described in subparagraphs (i) to (iii)."

(4) The particular expense must meet the conditions in one or more of paragraphs 186(1)(a) to (c).

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ILPs and ITCs
Section 186 – Proposed changes

Paragraph 186(1)(a)

- Property or service acquired or imported or brought into a participating province for the purpose of
  - Selling or otherwise disposing of, purchasing or otherwise obtaining, or holding units or indebtedness of the operating corporation, or
  - Redeeming, issuing or converting or otherwise modifying units or indebtedness of the operating corporation by the operating corporation

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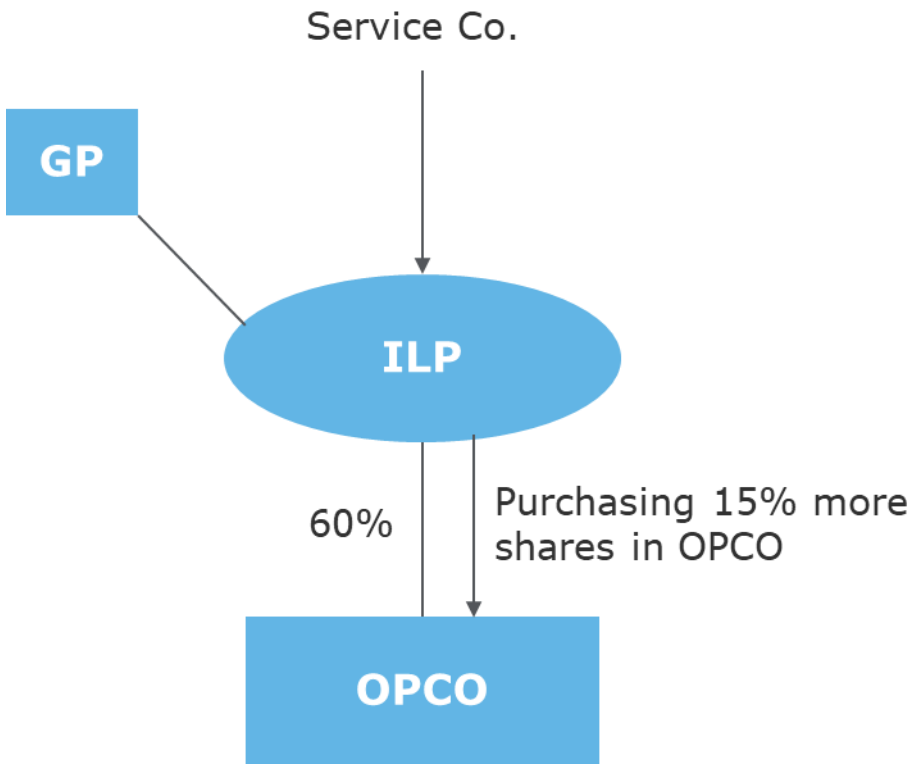
ILPs and ITCs
Section 186 – Proposed changes

Paragraph 186(1)(a) – Example

- GP acquires on behalf of ILP legal services for the purpose of ILP purchasing an additional 15% shares in OPCO.
- ILP should be entitled to claim ITCs with respect to the GST/HST paid on those legal fees.



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ILPs and ITCs
Section 186 – Proposed changes

Paragraph 186(1)(b)

- Property of service is acquired, imported or brought into the participating province for the purpose of issuing or selling units or indebtedness of the parent;
- The proceeds from the issuance or sale is transferred to the operating corporation by lending money, purchasing (or otherwise obtaining) from the operating corporation units or indebtedness of the operating corporation; and
- The operating corporation uses the proceeds transferred in the course of its commercial activities.

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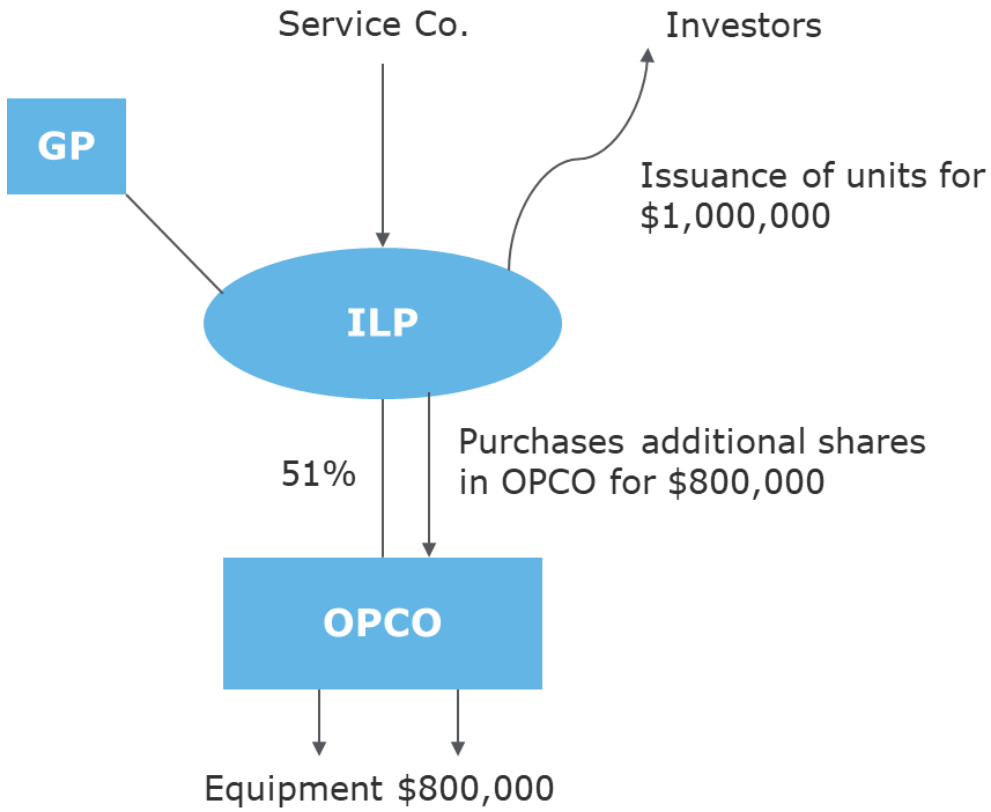
ILPs and ITCs
Section 186 – Proposed changes

Paragraph 186(1)(b) – Example

- ILP acquires legal services in order to issue partnership units to a new investors in the ILP, which will generate $1,000,000 of additional capital.
- ILP will use $800,000 to acquire additional shares in OPCO.
- OPCO will use the $800,000 to acquire equipment and machinery that it uses in its commercial activity.
- ILP should be entitled to claim an ITC of 80% on the GST/HST paid on the legal fees. calculated as follows:
  - 80% of the money raised through the issuance of units was transferred to OPCO
  - 100% of the money received by OPCO was used in the course of its commercial activities
  - 80% * 100% = 80%.



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ILPs and ITCs
Section 186 – Proposed changes

Paragraph 186(1)(c)

- Property test
  - At the particular time, all or substantially all of the property of the parent (ILP) is:
    - (i) Property that was manufactured, produced, acquired or imported by the parent for consumption, use or supply exclusively in the course of its commercial activities,
    - (ii) Property that is units or indebtedness of operating corporations of the parent, or
    - (iii) A combination of property noted in (i) and (ii).
- ITCs available for:
  - The property or service acquired, imported or brought into the participating province for the purpose of carrying on, engaging in or conducting of an activity of the parent other than
    - (i) Activity that is primarily in respect of units or indebtedness of a person that is neither the parent or an operating corporation of the parent, or
    - (ii) Activity carried on, engaged in or conducted in the course of making an exempt supply by the parent, unless the activity is a financial service that is listed in clause (A) to (E).

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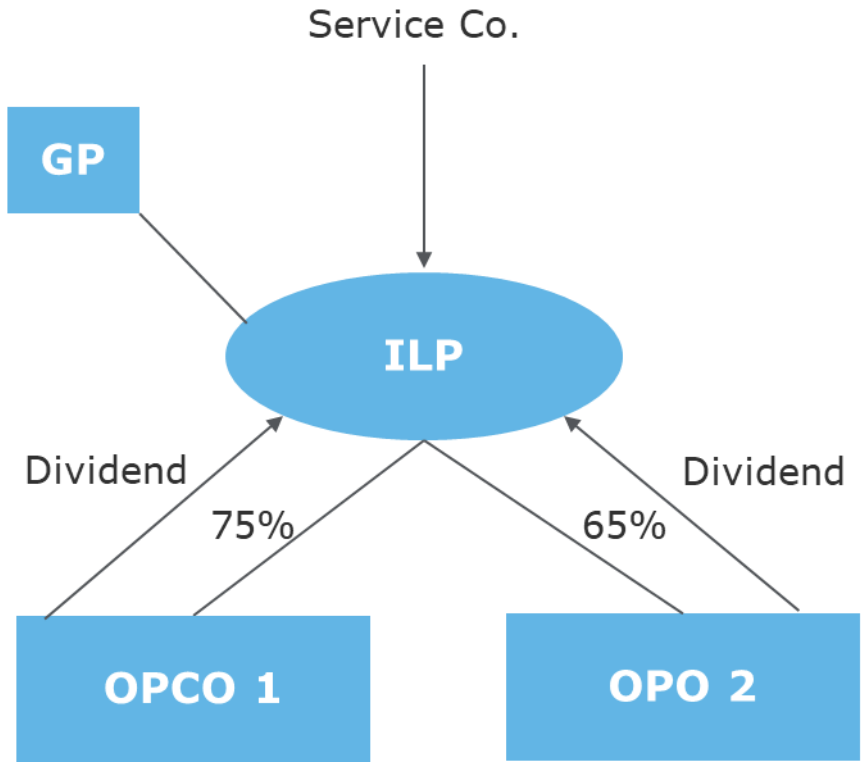
ILPs and ITCs
Section 186 – Proposed changes

Paragraph 186(1)(c) – Example

- The assets held by ILP are: (i) 75% of the shares OPCO 1 and (ii) 65% of the shares in OPCO 2.
- The ILP incurs professional fees for the purpose of determining the accounting and tax treatment of the dividends it receives from OPCO 1 And OPCO 2.
- ILP should be entitled to claim an ITC with respect to the GST/HST paid on the professional fees.



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ILPs and ITCs
Conclusion

141.02

- More scrutiny from CRA
- Rules remain open to interpretation
- The Minister's powers should not extend to an ***entitlement*** to an ITC
- Is there a flaw with subsection 141.02(27)?

ILPs and ITCs

- ILPs are likely entitled to ITCs (i.e., supplies made to non-resident investors and non-resident investees)
- ILPs that are SLFIs must consider the effect of section 225.4 and perform a cost/benefit analysis
- Proposed changes to subsection 186(1)

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