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Tax Court of Canada overturns the CRA's policy on real property elections for public service bodies

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Two recent Tax Court of Canada decisions, *University of Calgary v. The Queen* (December 11, 2015) and *University of Alberta v. The Queen* (December 21, 2015), rejected the goods and services tax (GST) policy¹ of the Canada Revenue Agency (CRA) concerning the claiming of input tax credits (ITCs) where a public service body (i.e., a non-profit organization, charity, municipality, school authority, hospital authority, public college or university) files a real property election under section 211 of the Excise Tax Act (ETA).

These decisions² effectively override the position noted in the CRA Audit Manual – *Section 211 Elections: A Roadmap for Auditors*, that requires public service bodies (PSBs) to use an indexing factor that weighs the relative value of each part of real property based on construction costs and excludes any external common areas (e.g., roads, sidewalks, landscaping and forests) as not being used in any commercial activities. The CRA's policy had significantly reduced the amount of eligible ITCs that a PSB could claim under certain circumstances.

The Tax Court's reasoning in finding for the appellants is consistent with the *Sun Life* case which stated that the CRA cannot simply substitute its allocation method, as a GST registrant is entitled to use any method that is fair and reasonable if it complies with the GST legislation.

Background

Generally, a PSB is entitled to claim ITCs in respect of all of the GST paid on capital real property (i.e., land and buildings and any additions, alterations, improvements, etc.) only if the property is used primarily (i.e., more than 50%) in the PSB's commercial activities. If this primary use test is not met, then the entity may claim a PSB rebate in respect of all of the GST paid, but may not claim ITCs.

However, an elective provision (under section 211 of the ETA) allows a PSB that does not use capital real property primarily in commercial activity, but does use the property at least 10% in commercial activity, to recover an ITC to the extent of the actual use of the property in commercial activity, with a PSB rebate available on the

¹ This policy would also apply to the Harmonized Sales Tax and Quebec Sales Tax.

² The cases were heard together. However, the Court issued two separate judgements.

remaining tax paid (i.e., the non-creditable tax charged). The election is made with respect to the smallest described parcel of land and any determination of the actual extent of use in commercial activities must be fair and reasonable. Typically, PSBs determine the extent of use of capital real property in commercial activity by a method that involves determining the use of space (the so-called "Sqft method").

The two cases dealt with the determination of the use of external common areas located on certain of the universities' campuses under the Sqft method and on the imposition of a weighting factor applied to different types of space. Essentially, the universities' position was that the external common areas should be regarded as having been used in commercial activities to the extent that all other spaces (buildings, parking lots, etc.) were used in those activities.

The CRA disagreed and assessed both universities based on the position that none of the external common areas were used in any activity and, therefore, could not be regarded as having been used to any extent in commercial activities. Further, the CRA asserted that its weighting factor should be applied to each different type of space (based on replacement cost) to reflect the relative cost of that space. For example, buildings are more expensive than parking lots, which are more expensive than landscaped areas, which are more expensive than waste ground. As a result, the CRA's view was that a factor should be applied to the space to reflect the overall tax incurred on that space.

The effect of the CRA's approach versus that of the universities was to reduce the overall extent to which the entire campus was used in commercial activities, thus reducing the amount eligible for ITCs.

The universities appealed the CRA's assessment that external common land is not used to any extent in commercial activities and also appealed the imposition of the weighting factor. The appeal was allowed by the Tax Court of Canada.

What does this mean for your organization?

A PSB that has filed a section 211 election following the CRA's guidance is advised to review the overall allocation methodology and compare it to the allocation available as a result of the Tax Court of Canada's decisions. In most cases, this would likely result in an increase in the overall extent of commercial activity, but the actual impact would have to be calculated on a case by case basis.

In order to substitute a new method, it will be necessary to establish that the previous method was not fair and reasonable in the circumstances. The CRA will most likely reject any new methodology solely on the basis that it increases the available ITCs. The general anti-avoidance rule would also have to be considered.

It is important to note that an appeal was filed on January 11, 2016 with respect to the *University of Calgary* case and that the CRA is actively reviewing its policies governing these real property elections.

Deloitte's Indirect Tax professionals have significant experience in establishing eligibility for and preparing section 211 elections. We will be carefully monitoring developments in this area and are available to assist your organization in reviewing your current allocation methodology and recommending possible optimization strategies.

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