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Tax Alert – Canada

Finance releases draft amendments and proposals for ETA section 186 holding corporation rules: update

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 17 May 2019 (the announcement date), the Department of Finance (Finance) released a package of draft legislative proposals and explanatory notes relating to the holding corporation rules contained in section 186 of the *Excise Tax Act* (the ETA, or the Act). These proposals would extend the application of the rules to include holding partnerships and trusts. Finance also indicated that it had considered submissions from industry stakeholders and other interested parties relating to the original legislative proposals released on 27 July 2018, as well as a consultation paper released on the same day.[1]

In addition to the proposed changes to the holding corporation rules, Finance has released draft amendments to the ETA that would:

- Extend the application of the drop shipment rules to commercially interchangeable or fungible goods
- Treat virtual currency as a *financial instrument* for Goods and Services Tax (GST)/Harmonized Sales Tax (HST) purposes
- Expand the definition of a *freight transportation service* so that zero-rated international freight transportation services would include international driving services

Interested parties are invited to provide comments on these legislative proposals by 17 June 2019.

[1] Refer to EY Tax Alert 2018 No. 32.

Building a better working world

Holding corporations

Section 186 of the ETA provides that where a registered Canadian corporation (the parent) holds shares or debt of a related corporation (the operating corporation, or Opco) that is exclusively (generally, 90% or more) engaged in commercial activities at the time GST/HST is paid or becomes payable on expenses that can reasonably be regarded as having been incurred in relation to the shares or debt of the operating company, the parent corporation is deemed to have incurred those expenses in the course of its commercial activities. Therefore, the parent may recover the tax as an input tax credit (ITC).

Finance released draft legislative proposals (the 2018 proposals) and a consultation paper on 27 July 2018, both of which proposed changes to the rules in section 186.[2] The proposals released on 17 May 2019 (the 2019 proposals) largely reflect the 2018 proposals, subject to some modifications.

As with the 2018 proposals, the 2019 proposals would broaden the "commercial operating corporation property test" that an Opco must meet for the parent to benefit from the holding corporation rules, by including property that was last manufactured or produced by the Opco. Similar amendments would apply to the voluntary GST/HST registration rule in paragraph 240(3)(d). These amendments address the issue raised in a 22 January 2018 comfort letter, in which the Canada Revenue Agency (CRA) acknowledged that the lack of a reference to property that was "manufactured or produced" in the commercial operating corporation property test could prevent a parent corporation from claiming ITCs in otherwise appropriate circumstances.

The 2019 proposals also specify certain circumstances under which the parent corporation can claim an ITC under the holding corporation rules for expenses it incurred. Proposed paragraph 186(1)(a) of the Act would deem a parent corporation to acquire a property or service in the course of its commercial activities, thereby allowing it to claim an ITC, if it acquired or imported the property or service, or brought it into a participating province, for the purpose of:

- Enabling the parent to sell, purchase or hold units (e.g., shares) or debt of the operating corporation; or
- Enabling the operating corporation to redeem, issue, convert or otherwise modify its units or debt.

[2] Ibid.

Under proposed paragraph 186(1)(b), a parent corporation could also claim an ITC in respect of a property or service where:

- The parent acquired, imported or brought the property into a participating province in order to issue or sell units or debt of the parent;
- The parent transferred the proceeds from the issuance or sale of the units or debt to the Opco by lending it money or by acquiring units or debt of the Opco; and
- The transferred proceeds are for use in the course of the Opco's commercial activities.

It should be noted that under the 2018 proposals, the operating corporation would have been required to use the proceeds exclusively in the course of its commercial activities; however, the word "exclusively" is omitted from the 2019 proposals. As well, the 2019 proposals omit the requirement that paragraph 186(1)(b) applies to the extent that "the following conditions are met," which appears to be a less stringent test and allows for some apportionment of capital raised by the parent: for example, where the parent does not transfer all of the proceeds to the Opco because it uses some of the proceeds to repay existing debt.

New paragraph 186(1)(c) would apply where 90% or more of the property of a parent is:

- Property that was last manufactured, produced, acquired or imported by the parent for consumption, use or supply in the course of its commercial activities;
- Property that is units or debt of its operating corporations; or
- a combination of such property.

If the parent met this property test, the section 186 deeming provisions would apply where a parent acquired, imported or brought a property or service into a participating province for the purpose of carrying on, engaging in or conducting an activity of the parent, other than:

- An activity that relates primarily to units or debt of a person other than the parent or the Opco; or
- An activity that is carried on, engaged in or conducted in the course of making an exempt supply by the parent, unless the activity is a financial service specified under proposed subparagraphs 186(1)(c)(A) to (E).[3]

Under the 2018 proposals, a parent could avail itself of paragraph 186(1)(c) only if 90% or more of its property was shares or debt of its operating corporations. Some stakeholders contended that there did not seem to be a rationale for excluding a holding corporation that also held significant assets in commercial activity. The expanded property test in the 2019 proposals appears to address these concerns.

[3] For example, the payment of dividends in relation to units or debt of the parent.

The 2019 proposals discussed above would generally apply in respect of any property or service acquired, imported or brought into a participating province after 27 July 2018.

The consultation paper sought input from stakeholders in respect of two proposed amendments to the holding corporation rules. First, Finance suggested replacing the requirement that the parent corporation and the commercial operating corporation be related (i.e., one corporation controls the other corporation) with a requirement that they be closely related, meaning there is at least 90% common ownership among the corporations. The rationale for this suggestion was that section 186 was intended to apply where a holding corporation and an Opco effectively operated as a single entity, and that this criterion might not be met where, for example, a holding corporation held a 51% interest in an Opco. However, some stakeholders expressed concern over increasing the ownership threshold, contending that a parent corporation with majority ownership in an Opco would likely have significant influence over that corporation and would be responsible for acquiring properties or services relating to the Opco's shares. In these circumstances, there was no policy rationale for preventing the parent corporation from claiming ITCs for tax paid on acquisitions of such properties and services.

The 2019 proposals have not adopted a "closely related" requirement and maintain the existing "related" threshold.

Second, the consultation paper considered extending the application of the holding corporation rules to include partnerships and trusts on the basis that there was no GST/HST policy basis for preferring one business structure over another. In accordance with this proposal, new subsection 186(0.1) of the ETA would define a *unit* as a share of a capital stock of a corporation and is applicable in respect of any property or service acquired, imported or brought into a participating province after 27 July 2018. However, on the day after the announcement date, the definition of a unit would be expanded to include:

- In respect of a partnership, a partnership interest; and
- In respect of a trust, a trust unit.

Subsection 186(0.2) sets out when a corporation is considered to be an operating corporation of another person that is a corporation, partnership or trust. Specifically, a particular corporation is an operating corporation if all or substantially all (generally, 90% or more) of the property of the particular corporation was last manufactured, produced, acquired or imported by the particular corporation for consumption, use or supply exclusively in the course of its commercial activities, and:

- Where the other person is a corporation or a trust, the particular corporation and the other person are related; or
- Where the other person is a partnership, the particular corporation is controlled by the partnership, a corporation controlled by the partnership, a corporation that is related to a corporation controlled by the partnership, or a combination of such persons.

As the proposals currently stand, it appears that only partnerships at the top of the chain would be eligible to claim ITCs. This is arguably an inequitable result, as it is does not account for situations where the Opco is a member of a partnership or where there are multiple partnerships in the chain.

The amendments relating to partnerships and trusts would be deemed to have come into force on the day after the announcement date.

Drop shipments

The drop shipment rules contained in section 179 of the ETA allow an unregistered non-resident to acquire goods and a broad range of services respecting goods in Canada without paying GST/HST. The rules apply where goods remain under the physical control of a registrant who has assumed responsibility to account for GST/HST if the goods are released to a person who will use the goods in Canada in non-commercial activities.

Proposed subsection 179(7.1) would ensure that the drop shipment rules apply to commercial services involving fungible goods. For example, the new rules would apply where:

- A registrant obtained physical possession of the original tangible personal property for the purpose of supplying a service of manufacturing or producing tangible personal property (the manufactured property); and
- Substitute tangible personal property was directly consumed or expended in manufacturing or producing the manufactured property.

The original tangible personal property and the substitute tangible personal property would be required to have essentially identical properties and be commercially interchangeable. Assuming these conditions are met, subsection 179(7.1) would allow for the application of the drop shipment rules by deeming the substitute tangible personal property to be the original tangible personal property.

In accordance with current administrative policy, these amendments would not extend the application of the drop shipment rules to continuous transmission commodities (e.g., natural gas) that are transferred to a consignee by means of a wire, pipeline or other conduit. For example, the drop shipment rules would not apply where:

- A Canadian registrant supplies natural gas to a non-resident non-registrant;
- The natural gas is transported by means of a pipeline owned by a third-party carrier;
- The supplier transfers ownership to the non-registrant at a specified delivery point; and
- The non-resident subsequently transfers the same quantity of natural gas to a Canadian registrant purchaser.[4]

[4] RITS 49409 – Supply of Natural Gas.

The drop shipment rule enhancements would generally apply to supplies of services made after the announcement date. However, they would also apply retroactively to any supplies of services where GST/HST was payable on or before the announcement date, but GST/HST has not yet been collected by the supplier (i.e., an invoice has been issued but has not yet been paid).

Virtual payment instrument

The definition of a *financial instrument* under subsection 123(1) of the Act is amended to include a *virtual payment instrument* as a financial instrument. A virtual payment instrument would be defined as property that:

- Is a digital representation of value that functions as a medium of exchange, like money; and
- Exists only at a digital address of a publicly distributed ledger.

However, a virtual payment instrument would not include property that confers a right to be exchanged or redeemed for money or specific property or services. It would also not include property that is primarily for use within a gaming platform, an affinity or rewards program, or similar platforms and programs.

Paragraph (d) of the definition of *financial service* in subsection 123(1) of the ETA provides that a financial service includes "the issue, granting, allotment, acceptance, endorsement, renewal, processing, variation, transfer of ownership or repayment of a financial instrument." Supplies of financial services are treated as exempt supplies under the ETA. Therefore, the net effect of treating virtual payment instruments (e.g., bitcoin) as financial instruments is that suppliers would not be required to charge and collect GST/HST on supplies of virtual currency. It should be noted that in a 2013 news release,[5] the CRA stated that virtual currencies could be bought and sold like a commodity. Therefore, while GST/HST does not apply to currency conversions, it generally applied to the acquisition of digital currencies.

The proposed amendments should prove to be a welcome clarification of the application of GST/HST to virtual currency and should simplify registration, reporting and remittance requirements for suppliers of such currencies. Suppliers of virtual currency could be subject to additional compliance obligations including the Annual Information Return, if they are considered to be a "financial institution."

If enacted, these amendments will be deemed to have come into force on the day after the announcement date.

Freight transportation service

In accordance with Part VII of Schedule VI to the ETA, certain supplies of transportation services are zero-rated. The proposals would expand the definition of a *freight transportation service* to include a service of driving an automotive vehicle that is designed for use on highways and streets for the purpose of delivering the vehicle.

[5] CRA NEWSWIRE – What you should know about digital currency (November 5, 2013).

This amendment would generally apply to supplies of freight transportation services made after the announcement date. However, these changes will also apply retroactively to any supplies of freight transportation services where GST/HST was payable on or before the announcement date, but GST/HST has not yet been collected by the supplier.

Learn more

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