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Tax Newsletter

Topics for discussion:

- Section 186 – Holding corporation rules
- Changes to QST for businesses outside Québec
- South Dakota vs. Wayfair Inc.
- Around the courts

Section 186 – Holding corporation rules

The Department of Finance released proposed amendments to section 186 of the Excise Tax Act ("ETA") on July 27, 2018. The amendments impact businesses that use holding corporation structures and claim input tax credits ("ITC") to recover GST/HST on expenses incurred with respect to a commercial activity of their subsidiaries.

Per the current rules, a Canadian-resident holding corporation can claim ITCs if the following three tests have been met:

1. **Related test**: Holding corporation is related to the operating corporation at the time particular supply is acquired.

2. **Property test**: All or substantially all property acquired was used for commercial activity.

3. **Purpose test**: Expenses reasonably relate to the shares or indebtedness of the related corporation.

Overall, the existing rules and regulations are interpreted in a broad manner, wherein the section deems that a holding corporation carries on commercial activity and allows ITCs for expenses if related to its subsidiary's activities.

The proposed amendments narrow the scope of interpretation for what is considered "related" and which activities would be eligible for ITCs. Under the new rules, the holding corporation needs to be "closely related" to the operating corporation meaning that the holding corporation has at least 90% common ownership. This is a drastic departure from the existing rules, wherein a holding corporation with a common ownership of 51% would be eligible for the ITCs; this would no longer be possible if the amendments are to be enacted.

Moreover, the property test outlined above is broadened to consider property that is last manufactured, produced, acquired, or imported by the operating corporation and whether all or substantially all of it was used for commercial purposes. This amendment was in response to a comfort letter, dated January 22, 2018, wherein the Canada Revenue Agency ("CRA") highlighted the lack of reference to manufactured or produced property in the property test.

The amendments also outline specific circumstances under which the holding corporation can claim ITCs for the expenses incurred. A parent corporation may be deemed to have acquired property/service in the due course of commercial activity for the purposes of:

- Selling, purchasing, or holding shares or debt of operating corporation; or
- Redeeming, issuing, converting, or modifying the indebtedness or capital stock.

ITCs can also be claimed with respect to property or service where:

- Holding corporation acquires, imports, or transports the property into participating province to issue or sell shares or debt;
- Holding corporation transfers proceeds from the issuance or sale to the operating corporation thru a means of a loan or acquisition of shares; or
- Operating corporation uses funds exclusively for the commercial activities.

Essentially ITCs can be claimed on expenses incurred to raise capital through the issuance of shares or debt and the proceeds from the issuance will be used for commercial purposes.

Per the changes, paragraph 186(1)(c) will specifically apply to holding corporations that primarily comprise of shares or debt of a related operating corporation. If property of the operating corporation is all or substantially all (90% or more) used for commercial activities, then ITCs may be claimed.

These amendments limit Canadian-resident holding corporations' ability to claim ITCs; they also increase the compliance measures and costs to ensure whether the expenses for ITCs claimed meet specific conditions. There is a high likelihood that not all expenses will meet the stringent criteria mentioned above; thus, it calls for a fair and reasonable allocation method to calculate the ITCs. This follows with a high risk that the CRA will question and audit an increasing number of holding corporations for ITC claims and will lead to increased time, effort, and monetary resources as a taxpayer to substantiate the claims.

Moreover, there are talks about extending the application of holding corporation rules to partnerships and trusts on the assumption that they act as a parent corporation. This stance is driven by the CRA's position that no one structure is more preferable than another. This increases complexity because determining whether partnerships or trusts are related is not as simple as evaluating voting rights of a holding corporation.

Changes to QST for businesses outside Québec:

In its 2018-2019 budget[1], Revenu Québec proposed changes to the QST system that would require certain businesses outside of Québec (non-resident suppliers) to collect and remit QST. Previously, if a business had no physical presence in Québec it was not required to register with Revenu Québec or remit QST. This meant that Québec consumers were required to self-assess the QST payable on services, tangible, and intangible property purchased from elsewhere within Canada.

Effective September 1, 2019, Canadian suppliers outside Québec who meet certain criteria will have to be registered for QST and collect and remit the tax. For suppliers outside of Canada, the mandatory registration date is January 1, 2019. The criteria to be met for the new rules to apply are below[2].

Who is affected?

Canadian suppliers: mandatory registration before September 1, 2019

- This applies to Canadian suppliers:
    - with no physical or significant presence in Québec;
    - that are not already registered for the QST;
    - that generate over $30,000 in taxable sales to specified consumers in Québec;
    - that supply services and intangible movable property in Québec.

1. "The Québec Economic Plan", *Revenu Québec* , 27 Mar. 2018, http://www.budget.finances.gouv.qc.ca/budget/2018-2019/en/documents/AdditionalInfo_18-19.pdf#page=137.
2. "Ensuring Tax Fairness in the Digital Economy." *Revenu Québec*, 27 Mar. 2018, www.revenuQuébec .ca/en/press-room/tax-news/details/152500/.

Foreign suppliers: mandatory registration before January 1, 2019

- This applies to foreign suppliers:
    - with no physical or significant presence in Québec;
    - that are not already registered for the QST;
    - that generate over $30,000 in taxable sales to specified consumers in Québec; and
    - that supply services and intangible movable property in Québec.

Digital platforms will also be subject to the new rules if they have control over key elements of a transaction between non-resident suppliers and Québec residents, such as billing or delivery. Some digital platforms will be exempt from registering for QST providing they:

- Only supply a transport service (i.e. a delivery method for the content);
- Only provide access to a payment system, or;
- Only provide advertising services for non-resident suppliers and link Québec customers to the supplier's website.

The calculation of the $30,000 threshold will be different for digital platforms. Digital platforms will have to include in their calculations the consideration for all taxable supplies the platforms facilitate. Because of this, suppliers will not have to include those considerations in their $30,000 threshold, unless the supplier sells the intangible property through both the digital platform and other means.

Collecting and remitting

Non-resident suppliers registering under the new mandatory system will be required to file QST returns every calendar quarter with payment of taxes due within one month of the quarter end.

Suppliers registered under the new system will not be able to claim an input tax refund (ITR).

Québec customers who are currently registered under the existing general registration system who pay QST to a non-resident supplier registered under the new mandatory system cannot claim an ITR for those payments.

Suppliers will have to identify whether their customers are **specified Québec consumers** before collecting QST on their transactions. A specified Québec consumer is **someone who is not registered for QST and whose usual place of residence is in Québec** [3]. This may include an individual, a financial institution, health care provider, or a similar entity who is not required to collect QST.

3. "The Québec Economic Plan", *Revenu Québec*, 27 Mar. 2018, http://www.budget.finances.gouv.qc.ca/budget/2018-2019/en/documents/AdditionalInfo_18-19.pdf#page=137

To identify if their customers meet this definition, suppliers will be required to obtain **two** non-contradictory pieces of information showing the customer's place of residence. Information may include a billing address, IP address, bank information, etc.

Taxes paid in error

Specified Québec consumers who pay QST in error to a supplier registered under the new system will be eligible to request a refund from either the supplier or Revenu Québec. However, consumers who are registered for QST will not be eligible to claim the refund from Revenu Québec and will have to request it directly from the supplier.

Penalties

There will be penalties applied to consumers who claim not to be a specified Québec consumer by providing false information, such as incorrect addresses or providing an erroneous QST number, to avoid paying QST to a non-resident supplier. The penalty will be equal to or greater than $100 or 50% of the QST payable on the transaction.

No penalties will be applied in the first 12 months to non-resident suppliers who are able to demonstrate that they are making reasonable efforts to comply with the changes but are still unable to meet the obligations. In this case, Revenu Québec will assist the suppliers in meeting their obligations. After the initial 12-month period, penalties will be imposed similar to those already in the existing tax legislation. Such penalties[4] include a $25 per day failure to file penalty (to a maximum of $2,500) and a late filing penalty ranging from 7% to 15% of the amount outstanding depending on how late the payment is.

Registration

A non-resident supplier may elect to register under the existing QST system if they meet the optional registration requirements, however in doing so, they will be required to also register for GST/HST and be required to provide security "of a value and in a form that are satisfactory to the Minister of Revenue", typically 50% of the estimated first year net taxes.

Revenu Québec will launch a new online service to support the registration for the new QST system for those suppliers who did not elect to register under the existing system. The system will be simple, with QST returns being filed electronically. There has been no word on whether Revenu Québec will require security from non-residents, but it is likely they would require something similar to the existing GST/HST system for non-residents.

4. "Penalties." *Revenu Québec*, 2018, www.revenuQuébec .ca/en/fair-for-all/ensuring-tax-compliance/penalties-and-interest/penalties/.

South Dakota vs. Wayfair Inc.

A recent US Supreme Court ruling on South Dakota v. Wayfair Inc. has overturned the precedent case set by Quill and National Bellas, which would require online retailers to collect and remit state taxes without having a physical presence in the state. In 2016 South Dakota passed a legislation that required out-of-state sellers to collect and remit state taxes if:

- More than $100,000 of goods and services are delivered within the state; or
- More than 200 separate transactions have occurred within the state.

There were two competing theories that were considered in reaching this decision: The Due Process Clause and the Commerce Clause. The Due Process Clause entails that a definitive link must exist between the state and person accountable for the collection and remittance of taxes. Quill and National Bellas set a precedent in interpreting the Due Process Clause which requires a physical presence in the state through a permanent establishment or hiring of employees. The position was such that physical presence was the substantial nexus in ruling whether the person was accountable for collecting and remittance.

The Commerce Clause pertains to whether Congress could regulate commerce among several states. There is a negative perception in this stance, as ideally the judiciary system should be responsible for setting precedents. It is also argued that the states cannot take regulatory actions that would interfere with interstate commerce, as it would in this case.

It was Appeals Justice Anthony Kennedy's position, that "a retailer doing extensive business within a state has sufficient substantial nexus to justify imposing some minor tax collection duty even if the business is done through mail or Internet." The key purpose of this ruling is to mitigate sheltering income from state taxes by limiting physical presence in a particular state. As a result of a reduction of lost state tax revenue to online transactions, approximately 40-plus states have, or are in the process of, implementing similar legislation.

How does this case precedent impact Canadian businesses? Considering the enormity of the case precedent, several states are enacting similar legislation that would apply a lower threshold of economic nexus as early as September, if not January. It is anticipated that Congress will be passing legislation across all the states to prevent any retroactive measures and uniformity across each state. Thus, Canadian businesses that transact limited services in the US may have VAT tax obligations and filing requirements in multiple states. This would increase compliance costs as it will require tracking of sales in different states and with respective state rates.

On the other hand, the advancement in technology would also reduce the tediousness of information gathering and programs such as Taxjar may be integrated to mitigate exposure and compliance costs. Taxjar is a program that generates reports from integration with ecommerce platform such as Amazon, Paypal, Etsy, Square and Shopify. These reports can show sales and sales taxes collected in each state and the data can be sorted through jurisdictions for any date

range. This precedent also facilitates estimation and filing of tax reports and can mitigate exposure to VAT assessments and unexpected tax bills.

Overall, there is an increased focus on compliance and accountability of sales taxes across US, Canada, and EU. This is an attempt to ensure digital business activities do not escape income tax as a result of minimal physical presence and keep pace with advanced technologies that allow international or inter-state/province commerce.

Around the courts

Mortgage lender lost out to borrower's pre-existing GST debt

In *The Queen v. Toronto-Dominion Bank*, 2018 FC 538, a Mr. Weisflock was in the landscaping business as a sole proprietor. In 2007-2008, he accumulated some $68,000 of unremitted GST, which he had collected but did not remit.

In 2010, Weisflock and his wife took a line of credit from TD Bank, secured by their home, which was registered in his name. A year later he sold the home and repaid the loan to the bank, discharging the mortgage.

The CRA then sued the bank in Federal Court for the $68,000 that the bank received back from Weisflock. This was because section 222 of the *Excise Tax Act* (the GST/HST legislation) imposes a deemed trust on Weisflock's property despite any security interest and required "proceeds" of the property to be paid to CRA "in priority to all security interests".

The Court agreed with the CRA and ordered the bank to pay the $68,000 to the CRA, along with pre- and post-judgment interest.

The bank has appealed this decision to the Federal Court of Appeal, so this issue is not yet finally resolved.

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