

HARMONIZED SALES TAX (HST)

and

CORPORATE COMMERCIAL LAW

(Areas of Interest to Corporate Commercial Lawyers)

Presented by:
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Introduction

This paper describes the following Harmonized Sales Tax (“HST”) practices and issues which practitioners should consider when dealing with their corporate files:

1. Charges between related parties should be analyzed to determine if the HST should be charged on them;
2. Receipts from medical practice Associates should be analyzed to determine if they are subject to HST;
3. HST business number of suppliers should be verified prior to making a payment to them and claiming an input tax credit. Purchasers should use Canada Revenue Agency’s GST/HST registry located at (<http://www.cra-arc.gc.ca/esrvc-srvce/tx/bsnss/gsthstrgstry/menu-eng.html>) in order to verify suppliers’ HST business numbers;
4. Annual or Block fees are normally subject to HST;
5. Purchasers must acquire ownership, possession or use of all or substantially all of the assets necessary to carry on a business in order to make the Excise Tax Act Section 167 Supply of Assets of a Business Election; and,
6. Holding companies should consider registering for the HST in order to claim input tax credits for the HST paid relating to their investments in shares or debt of subsidiaries and acquisition fees.

1. HST on Intercompany Charges

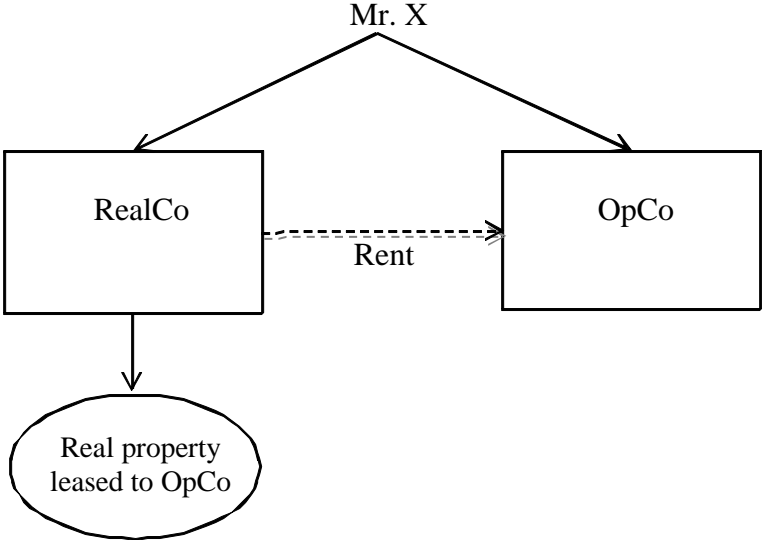
Issue

Charges between related parties should be analyzed to determine if the HST should be charged on them.

Analysis

Figure 1 is a diagram of a typical corporate structure. Mr. X owns two corporations: (a) “OpCo” which is an operating company which carries on an active business; and (b) RealCo, which owns a building and leases it to OpCo for use in its active business. RealCo charges OpCo commercial rent. This structure may have been set up to protect the Real Property from creditors of OpCo.

Figure 1: Related Party Rent Charges



RealCo must normally collect HST on the rental charge to OpCo. There are several factors to note:

- If OpCo and RealCo have less than \$30,000 of combined taxable supplies for HST purposes, then they can be considered small suppliers and RealCo will not have to collect HST on its rental charge to OpCo.
- Corporations which are members of a closely related group can make an Excise Tax Act Section 156(2) election to deem that transactions between them occur for nil consideration¹. As a result, HST does not have to be collected on transactions between them. Very basically, a corporation is closely related to another corporation if: (1) over 90% of the value and number of the corporation's voting shares are owned by the other corporation; or (2) over 90% of the value and number of the each corporation's voting shares are owned by the same corporation². Since OpCo and RealCo are owned by an individual they cannot be closely related corporations for HST purposes and the Section 156(2) election is not available.³
- Some would argue that the HST collectible by RealCo will be offset by the HST payable by OpCo and, therefore, it is unnecessary to collect the HST. Unfortunately, the HST is a transactions-based tax and the HST must be collected in this structure. The registrants could be subject to significant penalties and interest for failing to collect and remit the HST in this situation.

2. HST on Associate Fees

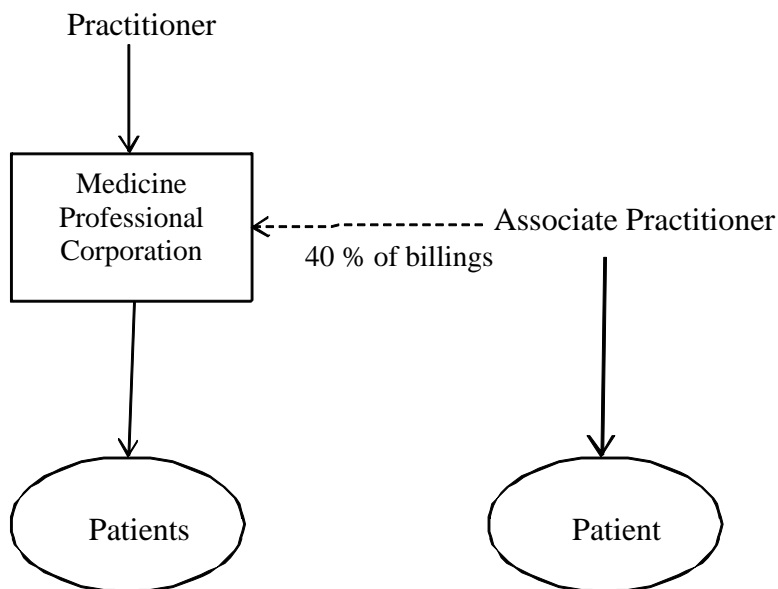
Issue

Receipts from medical practice Associates should be analyzed to determine if subject to HST.

Analysis

Figure 2 is a Medicine Professional Corporation (“MPC”), a structure used by many health professionals particularly where they have excess space in their practice and wish to generate extra revenue. The MPC contracts with an Associate to carry on his practice at the MPC’s location. The MPC will bill OHIP for the Associate’s billings and remit 60% of the OHIP billings to the Associate. The 40% retained by the MPC is consideration for the use of the MPC’s facility.

Figure 2: HST on Associate Fees



The Canada Revenue Agency (CRA) has commented on the above structure several times. In Policy Statement P-238 “*Application of the GST/HST to Payments Made Between Parties within a Medical Practice*” CRA provides an example in which a locum is contracted by a principal to provide treatment to the principal’s patients while the principal is on vacation, sick or at seminars etc. CRA indicates that the **HST is not applicable** to the payment by the principal to the locum:

“...Where the locum and the principal have entered into a bona fide arrangement to share fees irrespective of whether the locum or the principal is the initial recipient of the fees, the CCRA will not consider this to be a payment for the supply of administrative services made by the principal to the locum.”⁴

CRA provides some welcome additional guidance in Headquarter Ruling RITS 112247 dated July 7, 2009. CRA indicates that where a locum and principal have not entered into an agreement whereby the locum will set up his or her own practice at the principal’s office there is only one supply of a medical service, from the locum to the patient. The payment from the locum to the principal is outside of the GST/HST legislation and as such GST/HST does not apply to it.

However, the CRA indicates that **HST does apply**:

“...where there is an agreement between the principal and the locum whereby the locum agrees to pay for use of the medical practice facilities. In this situation, the principal has made a taxable supply to the locum which may consist of an administrative service or real property.”⁵

Therefore, where an Associate establishes her own medical practice at a clinic operated by a principal/medical practitioner who owns all the assets, and the Associate agrees to pay for the provision of administrative services and the use of facilities, then the payment is the payment for the provision of facilities, goods and services and is subject to HST.⁶ The CRA goes on to say that:

“If the facts are determinative that the principal's role is to provide the premises, equipment, supplies and administrative services to the locums or associates in order that the locums or associates may provide medical services to their patients, these facts would be determinative of a supply made by the principal to the locums or associates. Where the facts demonstrate that there is a supply made by one medical practitioner to another and consideration is payable for that supply, the GST/HST may be payable if that supply is taxable.”⁷

3. Proper Support for Input Tax Credits

Issue

The HST business number of suppliers should be verified prior to making a payment to them and claiming an input tax credit. Purchasers should use CRA's GST/HST registry located at (<http://www.cra-arc.gc.ca/esrvc-srvce/tx/bsnss/gsthstrgstry/menu-eng.html>) in order to verify suppliers' HST business numbers.

Analysis

In order to claim an input tax credit a purchaser must have the proper documentation to support it. Excise Tax Act 169(4) and the related regulations require, inter alia, the following documentation to be in place prior to claiming an input tax credit for a purchase of \$150 or more:

- Supplier name
- Supplier's registration number
- Amount of tax paid
- Date of invoice
- Total amount payable
- Recipient's name
- Terms of payment
- Description of the supply⁸

Several recent Court cases highlight the purchaser's obligation to obtain the proper HST business number of their supplier and to verify it. If the HST business number is not correct, the purchaser cannot claim an input tax credit even if the GST / HST was paid to the supplier.

SAMPLE CASE 1: In *Systematix Technology Consultants Inc. vs. The Queen* (2007 FCA 226), the purchaser (Systematix) paid GST on various sub-contractors' invoices. However, the sub-contractors gave Systematix GST business numbers that either:

- were never issued;
- had been revoked; or
- were the valid GST business number of another entity.

CRA disallowed the ITCs for the GST paid on the basis that Systematix did not have the information required to support the ITC, in particular a valid GST registration number of the supplier⁹.

SAMPLE CASE 2: In *Comtronic Computer Inc. vs. The Queen* (2010 TCC 55), Comtronic purchased computer parts from several suppliers over several years. The suppliers all had the same shareholder. The GST registration numbers that were given with the suppliers' invoices were an unrelated party's GST registration number. Again, the court disallowed the ITC claim on the basis that Comtronic did not have the documentation required to support the ITC claim. The Court also disallowed a due diligence defense on the basis that (1) Comtronic did nothing to validate the GST registration numbers; and (2) ignorance of the law is not a defence¹⁰.

4. Annual or Block Fees

Issue

Annual or Block fees are normally subject to HST.

Analysis

An annual or block fee (hereinafter referred to as "block fee" for purposes of this paper) is an "amount charged by physicians to their patients for the right to future services over a specified period of time"¹¹ Physicians may charge their patients for telephone advice, renewal of prescriptions by telephone, completion of various forms and patient related interviews or discussions with professionals, etc. which are not covered by provincial medical plans. Patients

may pay for these services on a service-by-service basis or the physicians may offer their patients the choice of paying a block fee in advance to cover the delivery of uninsured services.

At the time the block fee is charged to the patient there are no specific services rendered to the individual and the amount charged to the individual is not dependent on the amount of services actually rendered. The type of services to be rendered to the individual and the value of those services is not known at the time of the payment. The individual may receive more services than they paid for, or they may receive less. The services to be provided may be exempt medical services, taxable services or a combination of both.

CRA has ruled that block fees are subject to HST regardless of whether the block fees cover only otherwise exempt services or exempt and non-exempt services¹². It is CRA's position that the block fee is consideration for an intangible property and is therefore subject to HST:

“Annual or block fees are not consideration for a health care service rendered to an individual and at the time these fees are charged by a physician, no service was in fact rendered. Secondly, annual or block fees cannot be directly linked to any particular service provided as they are not dependent on the actual services provided. Annual or block fees are consideration payable by a patient for the "right" to future services. In effect, the annual or block fee is comparable to the purchase of a plan that covers a menu of services that a patient may request over the course of a specific time period. The "right" or the plan is not a supply of a service but of intangible personal property that is not exempt under section 5 of Part II of Schedule V to the ETA. Therefore, the annual or

block fee represents consideration for a taxable supply. However, if the physician were not a registrant, then no GST/HST would be collectible on the fee”

In a later ruling, a psychiatrist argued that the payment of a block fee for uninsured psychiatric services was an exempt medical service since it gave him a sense of security and which was therapeutic. CRA did not agree. It reiterated that at the time the block fee was paid there were no services rendered to the patient, the block fee cannot be linked to any future services rendered and that the block fee represents a payment for a right to future services. As such it is not a supply of services but is a supply of intangible personal property. Since the definition of “service” in ETA subsection 123(1) excludes property, it is impossible that the right for the future services could be a service.

5. Sale of a Business and Section 167

Issue

Purchasers must acquire ownership, possession or use of all or substantially all of the assets necessary to carry on a business in order to make the ETA Section 167 Supply of Assets of a Business Election.

Analysis

A sale of business assets by a commercial business is normally subject to the HST and, in the absence of any special compliance rules, normally the vendor will collect HST and the purchaser

will pay HST on the value of the consideration paid for taxable assets (equipment, goodwill, etc.). Because the magnitude of these transactions is often sizable, Excise Tax Act sub-section 167(1) contains special compliance rules that alleviate these transactions from HST in certain circumstances.

ETA sub-section 167(1) provides that:

“Where a supplier makes a supply of a business or part of a business that was established or carried on by the supplier or that was established or carried on by another person and acquired by the supplier, and, 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,

(a) for the purposes of this Part, the supplier shall be deemed to have made a separate supply of each property and service that is supplied under the agreement for consideration equal to that part of the consideration for the supply of the business or part that can reasonably be attributed to that property or service; and

(b) except where the supplier is a registrant and the recipient is not a registrant, the supplier and the recipient may make a joint election in prescribed form containing prescribed information to have subsection (1.1) apply to those supplies.”

There are various compliance requirements and other nuances of this election, however, this article will only focus on the requirement that the recipient acquire *“under the agreement 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 a business.”*

In order to determine if the Excise Tax Act Section 167 election can be made, the CRA has set out the following:

(i) Is the supplier selling, and is the recipient acquiring, "business"?

First Test

- A business is an activity including a profession, calling, trade, manufacture or undertaking of any kind pursuant to subsection 123(1) of the Act. Further discussion on the meaning of business is contained in Policy P-167R.
- The assets of a business generally include real property, equipment, inventory, and intangibles such as goodwill.
- In general, the supply of one or more individual assets will not be considered a supply of a business.
- The nature of a business will generally determine the package of assets that would comprise a business or part of a business. Generally, no one type of property, regardless of its value, is determinative that there is a supply of a business.

Second Test

- 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 (i.e. over 90% of the assets required to carry on the business must be acquired).
- 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.

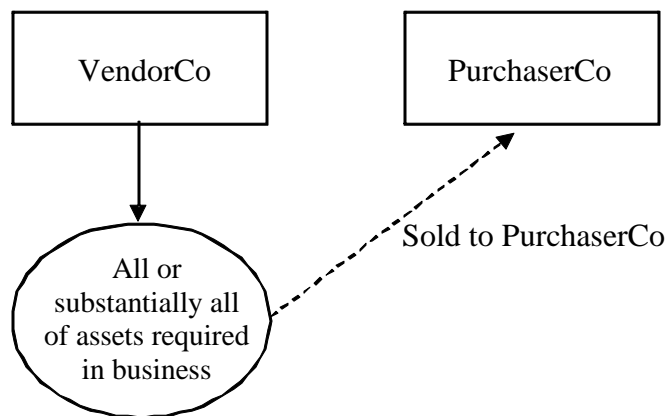
(ii) Is the supplier selling, and is the recipient acquiring, "part of a business"?

- In general, a "part of a business" is an activity that may be a functionally and physically discrete operating unit, or it may be an activity which supports or is related to the broader business but is organized as a separate activity which is capable of operating on its own.
- The two tests described above, together with the guidelines above, apply when determining whether there is a supply and acquisition of a "part of a business".¹³

EXAMPLE ONE

In Example One (see Figure 3) VendorCo is selling all or substantially all of the assets required to operate a business. PurchaserCo acquires all of these assets, for example its real property, inventory and prepaid expenses. Effectively, PurchaserCo steps into the same position as VendorCo. In this case, PurchaserCo has acquired over 90 per cent of the assets required to operate the business and this requirement of the election is met.

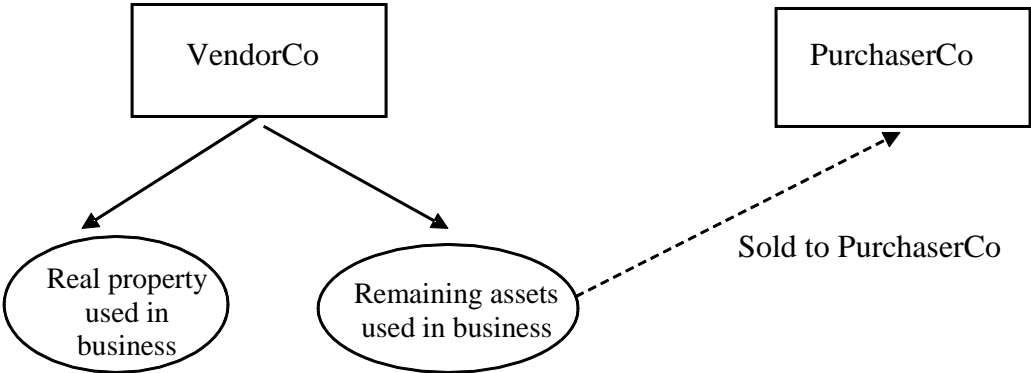
Figure 3: Example One



EXAMPLE TWO

In Example Two (see Figure 4), PurchaserCo will purchase all of the assets that are used in the business except the real property. This could be the case if PurchaserCo were to move the operations to their existing location. If the land is worth more than 10 per cent of the value of the assets required to operate the business, then the Excise Tax Act Section 167(1) election is not available and HST should be collected and paid on the sale of assets.

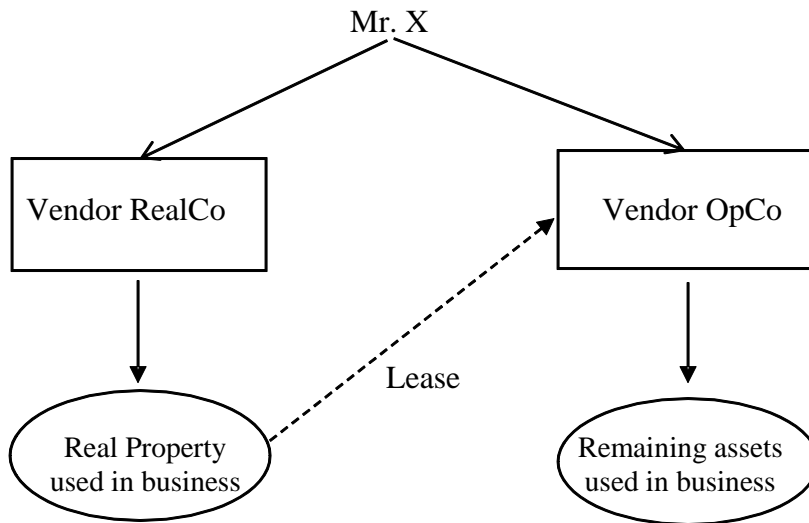
Figure 4: Example Two



EXAMPLE THREE:

In Example Three (Figure 5), Vendor RealCo owns real property that is leased to an associated company, Vendor OpCo, and used in its active business. This structure may have been set up to creditor-proof the real property from the creditors of Vendor OpCo.

Figure 5: Example Three



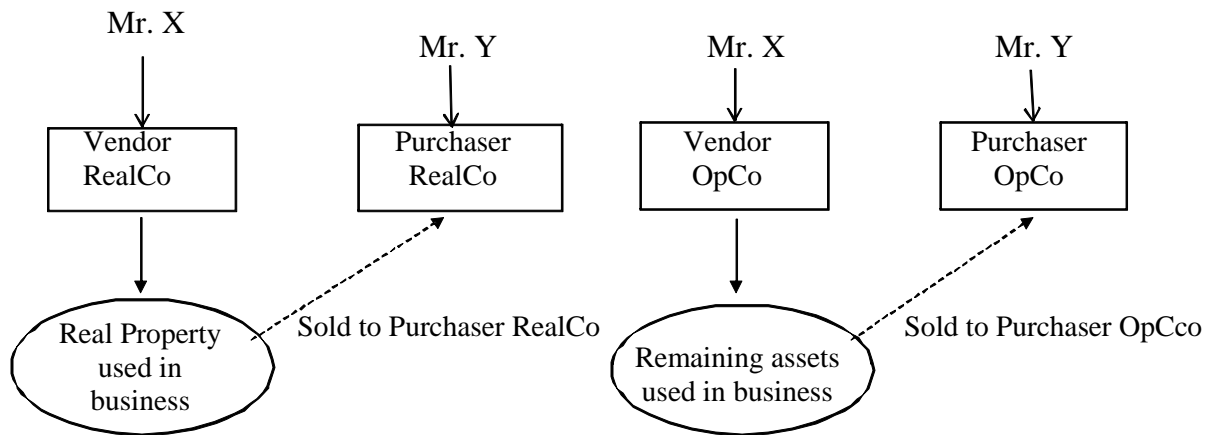
Assume that Purchaser RealCo will purchase Vendor RealCo’s real property and Purchaser OpCo will purchase the operating assets of Vendor OpCo. Purchaser RealCo and Purchaser OpCo are associated, (see Figure 6).

If Purchaser OpCo agrees to acquire all of Vendor OpCo’s operating assets and to assume the real property lease under the purchase and sale agreement, then Purchaser OpCo has acquired

ownership, use or possession of all or substantially all of the assets required to be used in the business.

If Purchaser OpCo agrees to acquire all of Vendor OpCo’s operating assets but does not assume the real property lease under the purchase and sale agreement, then Purchaser OpCo has not acquired ownership, use or possession of all or substantially all of the assets required to be used in the business and cannot make the Section 167 election. This could occur where Purchaser RealCo and Purchaser OpCo wish to negotiate their own lease¹⁴.

Figure 6: Example Three (cont’d)



6. Holding Companies and Input Tax Credits

Issue

Holding companies should consider registering for the HST in order to claim input tax credits for the HST paid relating to their investments in shares or debt of subsidiaries and acquisition fees.

Analysis

An input tax credit may be claimed for the HST paid to the extent a property or service is acquired for consumption use or supply in a commercial activity of a registrant.¹⁵ A commercial activity is basically an activity which is subject to HST at a 13% or 0% rate. In order to claim an ITC, the applicant must, inter alia, be registered for HST purposes and use the related expense in a commercial activity. The Excise Tax Act contains special rules that allow holding companies that otherwise do not carry on commercial activities to register for HST purposes and claim ITC's in certain circumstances.

Holding companies may register for HST purposes where they own shares of related corporations that use over 90 per cent of their assets in commercial activities.¹⁶

Excise Tax Act sub-section 186(1) provides that a holding corporation that acquires property or services that relate to the shares or indebtedness of a related corporation and over 90 per cent of the related corporation's property was acquired for use in commercial activities, the holding company is deemed to have acquired the property or service for use in commercial activities to the extent the property or service was acquired in relation to the shares or indebtedness. As a result, the holding company can claim ITC's for the HST paid on costs relating to its loans to and shares of related companies.

ETA 186(2) provides that where a registrant (the "purchaser") acquires a property or service relating to the acquisition or proposed acquisition of over 90 per cent of the voting shares of a corporation and the other corporation was (basically) over 90 per cent involved in commercial activities then the property or service is deemed to have been acquired for use in the purchaser's commercial activities. For example, assume an acquisition company is incorporated to acquire

the shares of Target. Target carries on only commercial activities. In this example, the acquisition company can register for HST purposes and claim an input tax credit related to the HST it pays on any costs of acquiring the shares of Target.

CRA has indicated that direct and indirect costs acquired or imported by the parent for consumption or use in relation to the shares or indebtedness of a related corporation qualify for ITC's. The parent must look at each cost and determine if there is a relationship between the property or service and the investment. If the cost only partially relates to the investment then the ITC's must be allocated to the commercial and non commercial activities¹⁷.

CRA's Policy P191 provides several examples of when ITC's would be allowed. For example, HoldCo has investments in related and unrelated companies. It employs several people to manage the investments and pays HST on office space and equipment that it provides to its employees. CRA indicates that HoldCo would have to determine the extent the ITC's relate to the acquiring, holding or disposing of the related corporations. ITC's would not be allowed to the extent the costs related to the unrelated companies.

In another example, HoldCo has investments in related companies that are involved wholly in commercial services. CRA's example indicates that ITC's are not allowed on costs incurred to raise capital in order to increase its investments in the related corporations. The Tax Court of Canada disagreed with this position in *Stantec Inc. vs. The Queen* ([2008] ETC 3021). The facts of the case were basically that Stantec was a Canadian public company that incurred professional fees in order to list its shares on the New York stock exchange. The listing was required in order

to merge two of Stantec's California subsidiaries. CRA disallowed the ITC's on the basis that they were incurred to acquire the New York Stock Exchange listing. The judge ruled that the ITC's were allowed on the professional fees since the fees related to Stantec's investment in the subsidiaries.

¹ Excise Tax Act Section 156(2)

² ETC 128(1)

³ ETA 128(1)

⁴ GST/HST Policy Statement P-238 Application of the GST/HST to Payments between Members within a Medical Practice Organization

⁵ GST/HST Policy Statement P-238 Application of the GST/HST to Payments between Members within a Medical Practice Organization

⁶ GST/HST Headquarters Ruling RITS 112247 dated, July 8, 2009

⁷ GST/HST Headquarters Ruling RITS 112247 dated, July 8, 2009

⁸ Regulations to ETA 169(4) the "Input Tax Credit Information (GST/HST) Regulations

⁹ Systematix Technology Consultants Inc v The Queen(2007 FCA 226)

¹⁰ Comtronic Computer Inc v The Queen (2010 TCC 55)

¹¹ GST/HST Headquarters Ruling 2002/08/06 RITS 34606

¹² See GST/HST Headquarters Rulings 2008/03/06 RITS 92711 and 2002/08/06 RITS 34606

¹³ Policy Paper 188 "Supply of a Business or part of a Business for the Purpose of the Election under Subsection 167(1)."

¹⁴ See GST/HST Interpretation Case number 84558

¹⁵ Excise Tax Act 169(1)

¹⁶ Excise Tax Act 204(3)(d)

¹⁷ CRA Policy P191 Whether Administrative Overhead Costs Fall Under 186(1)