Federal Court of Appeal: No GST/HST Leakage For Services Rendered to a Canadian Bank's Foreign Permanent Establishments

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In a recent Federal Court of Appeal ("FCA") decision, *CIBC World Markets Inc v The Queen*, 2019 FCA 147, the Canadian investment banking subsidiary ("Investment Dealer") of a large Canadian bank ("Bank") won its appeal of an adverse 2018 Tax Court of Canada ruling with respect to its claim for input tax credits ("ITCs"). The ITCs in question related to GST/HST paid on expenses attributable to certain exported supplies made by the Investment Dealer in connection with the Bank's activities outside Canada.

Background

Among its other activities, the Investment Dealer provides administrative services to the Bank in connection with the Bank's permanent establishments located outside Canada. In reporting periods from 2008 to 2013, the Investment Dealer claimed ITCs with respect to expenses allocable to those services.

As members of a "closely related group", the Bank and the Investment Dealer had elected under subsection 150(1) of the *Excise Tax Act* ("ETA") (a "150 Election"). As a result, supplies made between the two entities were deemed "financial services" and were thus exempt under section 2 of Part VII of Schedule V (the "Exempt Schedule"). Registrants that make exempt supplies cannot claim ITCs on inputs related to such supplies.

However, Part IX of Schedule VI of the ETA (the "Zero-Rated Schedule") establishes the general principle that exported supplies are zero-rated (i.e., taxed at 0%). Registrants may claim ITCs on inputs related to zero-rated supplies.

The Tax Court of Canada determined that a taxable supply originating in Canada and also deemed to be a financial service by virtue of a 150 Election remains an exempt supply, even where "exported" to a foreign branch.

On this appeal to the FCA, the Investment Dealer argued:

- that the Bank was in fact deemed to be a non-resident person with respect to its activities conducted through its foreign permanent establishments and thus cannot be party to or be bound by a 150 Election with respect to the supplies made in the course of these activities; and

- that the fiction created by subsection 132(3) ETA should have been given effect and that consequently the supplies in issue should have been taken as being made to a separate non-resident person.

Tax Court of Canada's Decision

Positions of the parties

The Crown's original position focused on the fact that the Investment Dealer and the Bank had entered into a 150 Election. Its reasoning can be summarized as follows:

1. Section 2 of Part VII of the Exempt Schedule provides specifically that any supply deemed under a 150 Election to be a financial service is exempt under such Schedule; and
2. Because registrants making exempt supplies may not claim ITCs on inputs related to such supplies, the Investment Dealer could not claim ITCs with respect to its supplies to the Bank's foreign branches.

On appeal, the Investment Dealer made two distinct arguments:

1. The 150 Election did not apply to the supplies because (on the basis of subsection 132(3) ETA) the Bank was deemed to be a "separate person" in respect of its activities outside Canada that were carried out through its non-resident branches; and
2. Such "separate person" was not a party to the 150 Election.

The Investment Dealer's alternative argument was that, even if the 150 Election was found to apply to the exported services, those deemed financial services would still be zero-rated under Part IX of the Zero-Rated Schedule as a supply of a financial service made by a financial institution to a non-resident person.

Reasoning of the Tax Court

The Tax Court identified the issues to be decided as follows: does the 150 Election deem supplies made to a non-resident branch to be exempt financial services for which no ITCs can be claimed? If so, is the appellant nevertheless entitled to the claimed ITCs on the basis that the exported financial services are zero-rated under the Zero-Rated Schedule, rather than exempt supplies under the Exempt Schedule?

The Tax Court identified a conflict between subsections 132(2) and 150(1) ETA, which it resolved by holding that the deeming rule in subsection 132(2) had a limited application (because it does not state that the non-resident branch, for the purposes of supplying goods and services, is a deemed separate person). The court determined that, had Parliament intended to deem the existence of separate persons, it would have used words similar to those used in subsection 132(4) which clearly deem permanent establishments "separate persons" for the purposes of providing supplies.

It follows from this conclusion that a conflict of purpose exists. Supplies exchanged between the Investment Dealer and the Bank are deemed, by virtue of the 150 Election, to be financial services and are also considered exempt supplies as per section 2 of Part VII of the Exempt Schedule. However, since the services were "exported" and not consumed in Canada, they can also be properly characterized as zero-rated supplies under Part IX of the Zero-Rated Schedule and be excluded of the Exempt Schedule as per section 1 of Part VII of the Exempt Schedule. The problem, therefore, is finding a way to reconcile the substantive effect of the 150 Election, which imposes GST/HST on financial services, with the overarching principle that exported supplies are not subject to GST/HST.

Based on the purposive analysis described in *National Bank Life Insurance v. Canada*, 2006 FCA 161, the Tax Court concluded that section 2 of Part VII of the Exempt Schedule overrides section 1 of the

same Schedule, which states that a supply of a financial service that is not included in Part IX of the Zero-Rated Schedule is exempt, and, as a result, the Investment Dealer was not entitled to the claimed ITCs.

The FCA Ruling

Positions of the parties

The Investment Dealer's only contention on appeal was that the supplies made to the Bank's foreign permanent establishments fell outside the scope of subsection 150(1) as the 150 Election thereunder could only be made by Canadian resident persons. According to the Investment Dealer, the Bank should have been considered as a non-resident person regarding its activities carried on through its foreign permanent establishments under subsection 132(3) ETA and thus the supplies made to the Bank's foreign permanent establishments should fall outside the scope of subsection 150(1). (para. 18)

In response, the Crown argued that pursuant to subsection 132(3) ETA, the Bank's foreign establishments were not deemed to be separate non-resident persons and that the FCA could not ignore the clear wording of both subsections 150(1) and 132(3) to achieve the correct tax policy objective. (paras. 21 and 24)

The issue

The issue was whether the 150 Election extended to all supplies made by the Investment Dealer to the Bank, including those made in connection with the activities carried on by the Bank through its foreign permanent establishments. (para. 26)

The decision

Conflict between subsections 150(1) and 132(3) ETA

In a decision rendered by Chief Justice Noël, the FCA rejected the Crown's contention that, since Parliament clearly expressed its intent in the provisions, a purposive and contextual interpretation could not alter the outcome. Justice Noël confirmed, as stated in *Hillier v. Canada (Attorney General)*, 2019 FCA 44, at paragraph 24, that even when a legislative provision seems to be precise and unequivocal, it is still necessary to examine the legislative purpose and context. (para. 27)

Subsections 132(2), (3) and (4) ETA are part of a scheme devised by Parliament for recognizing cross-border supplies made to and from permanent establishments to allow for the same tax treatment as would apply if the persons concerned had operated through the use of subsidiaries rather than permanent establishments. (para. 33)

Contrary to subsections 132(2), (3) and (4), subsection 150(1) ETA applies only to supplies within a closely related group and allows two or more members of such a group, if each of them resides in Canada, to file an election whereby inter-group supplies that would otherwise be taxable must be treated as exempt. (para. 34)

Chief Justice Noël further analyzed the context in which subsection 150(1) ETA was enacted and determined that a decision was made to treat financial services that are provided domestically as exempt supplies, while maintaining the general treatment applicable for financial services that are provided to non-residents. (para. 37)

Residency requirement

Chief Justice Noël then looked at the notion of residency under the ETA and determined that a permanent establishment had no legal personality of its own and that, absent specific rules, a supply made by a Canadian resident person to its foreign permanent establishment would not be recognized as such, since the supply requires the existence of two separate persons. (para. 31)

Contrary to the Tax Court decision, Chief Justice Noël concluded that the reference to two separate persons in subsection 132(4) ETA could be explained by the fact that two permanent establishments are involved and therefore, even if it is not specifically mentioned, subsection 132(3) ETA also contemplates the existence of two separate persons, i.e., the "resident person" itself and its "permanent establishment". (para. 42)

The Crown argued that subsection 150(1) ETA was also intended to eliminate the need to allocate ITCs when both domestic and cross-border supplies are made by the parties to a 150 Election. Chief Justice Noël rejected this argument because it ignored the fact that a 150 Election is restricted to Canadian resident persons and applies only to domestic supplies flowing between such persons. (paras. 52-53)

Chief Justice Noël also confirmed that applying subsection 150(1) ETA to deemed exported supplies under subsection 132(3) would defeat the tax neutrality which this provision is designed to achieve by imposing a less favourable and more onerous tax treatment on financial institutions that operate abroad through foreign branches rather than foreign subsidiaries. (para. 54)

Chief Justice Noël finally concluded that because the Bank was deemed to be a separate non-resident person with respect to the activities conducted through its foreign permanent establishments, the services provided to those establishments fell outside the scope of subsection 150(1) ETA and were not deemed to be financial services. The services must then be treated as zero-rated exported supplies by the combined operation of subsection 132(3) as well as sections 7 and 23 of Part V of the Zero-Rated Schedule and the Investment Dealer was therefore in a position to claim the ITCs. (para. 57)

Key Takeaways

Statutory interpretation

The FCA confirmed that even when a legislative provision seems to be precise and unequivocal, it is still necessary to examine the legislative purpose and context. When an ambiguity arises from this broader examination of two conflicting provisions, one has to determine whether they can be made to work coherently in a manner which gives effect to the statutory scheme. (paras. 27-28)

Activities of foreign permanent establishments

The FCA also determined that, in the context of a 150 Election, when a person is deemed to be a separate non-resident person with respect to its activities conducted through its foreign permanent establishments, the services provided to those establishments fall outside the scope of subsection 150(1) and must be treated as zero-rated exported supplies.

The ruling's effect on section 2 of Part VII of the Exempt Schedule

It is noteworthy that the FCA did not look at the application of section 2 of Part VII of the Exempt Schedule. In the Tax Court decision, Justice Bocock asked whether that section overrides section 1 of the same Schedule, which states that a supply of a financial service that is not included in Part IX of the Zero-Rated Schedule is in fact exempt. His finding was that it does. Prior to the enactment of section 2, deemed financial services under a 150 Election would fall either into the Exempt Schedule, if they were

consumed domestically, or the Zero-Rated Schedule, if they were exported. However, with the enactment of section 2 – which explicitly mentions deemed financial services captured by 150 Elections without making any differentiation between domestically consumed and exported services – such supplies are exclusively redirected to the Exempt Schedule as exempt supplies. In this respect, the FCA ruling appears to defeat the exact purpose for which section 2 of Part VII of the Exempt Schedule was enacted. It is likely that Parliament specifically targeted services rendered to foreign permanent establishments by enacting such provision.