Certain Services Outsourced By Fund Manager May Be GST/HST Exempt, Federal Court of Appeal Rules

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Reversing a ruling of the Tax Court of Canada, the Federal Court of Appeal has determined, with respect to a complex funding arrangement for broker commissions in connection with the sale of mutual funds' securities to investors, that the mutual funds received a GST-exempt supply of a financial service from a single-purpose entity established by a U.S. bank.

The key question in *SLFI Group v. the Queen*, 2019 FCA 217, was whether the mutual funds were required to self-assess GST in respect of the services rendered to them under the funding arrangement by virtue of the "imported taxable supply" rules under the *Excise Tax Act* ("ETA"), on the basis that such services were in fact taxable but made outside Canada.

Background

The appellants were a group of 72 mutual funds (the "Funds") and their manager Invesco Canada Ltd. (the "Manager"). The dispute concerned how certain commission payments were funded and, in particular, the tax consequences of the funding arrangement. When the Funds' securities were sold to third-party investors, the investors were given a deferred payment option that allowed them to avoid paying the commissions altogether if they remained invested in the Funds for a certain period. Because someone still had to pay the commission at the point of purchase, the Manager did so in place of the investors.

Initially, the Manager funded the payments in addition to making them. However, as of April 1, 2002, the Funds entered into a complex funding arrangement with Citibank, N.A., a U.S. bank ("Citibank"), under which the latter established a new single-purpose entity based in the U.S. ("FundCo") which agreed to arrange for daily payments that matched the brokers' deferred commissions. In return, the Funds agreed to pay certain fees to FundCo when they were earned by them (the "Earned Fees"). The rights to the Earned Fees were then transferred to Citibank by FundCo. Another entity, Citicorp, acted as agent for both Citibank and FundCo for the arrangement.

The transaction was structured in this manner principally to comply with securities regulations and to avoid certain business constraints.

Tax Court decision

For years, the Manager self-assessed GST (on behalf of the Funds who were not registered at that time) in connection with the funding arrangement with respect to a portion of the Earned Fees (as an imported taxable supply under Division IV of the ETA) and included the tax in its GST returns. However, from February 1, 2007 to June 30, 2010, the Manager systematically filed rebate applications, on behalf of the Funds, for tax paid in error after the issuance of the relevant notice of assessment by the CRA for each reporting period. The Manager's argument was that the GST was self-assessed and remitted in error. The CRA then denied all rebate applications and to the extent the Manager had not self-assessed the GST for the other relevant periods, also reassessed the Funds for an aggregate amount of nearly $45 million on the basis that they had acquired an imported taxable supply and that Division IV tax of the ETA had to be self-assessed for each relevant tax period.

In a 2017 decision, **the Tax Court of Canada ("TCC") dismissed the Funds' appeal of the reassessment**. Specifically, the TCC rejected the two key arguments made by the Funds: (i) that there was no supply and (ii) that, if there had been a supply, that supply was of a "financial service". (para. 28)

The TCC determined that there was in fact a supply of three main services to the Funds:

- arranging for the payment of funding amounts;
- receiving, processing and transmitting funding notices; and
- depositing the funding amounts in a trust account for the brokers' commissions. (para. 30)

The TCC then stated that such services constituted a single supply in which the dominant element was the daily payment of the funding amounts. (para. 31)

Although the TCC agreed that the single supply was, in theory, included in paragraph (a) of the definition of "financial service" in subsection 123(1) of the ETA and should therefore (at least *prima facie*) be a tax-exempt supply, it found the supply was nevertheless excluded from the definition of "financial service" under paragraph (q) in virtue of being a "management or administrative service" provided to an investment plan. In the TCC's view, the payment of commissions (including arranging for such payments) was a management duty of the Manager and any delegation of this duty (to the Citibank group, in this case) should not have an impact on its characterization.

The TCC accordingly held that the services rendered by FundCo constituted an "imported taxable supply" requiring a self-assessment of GST by the Funds. (paras. 33-34)

Federal Court of Appeal decision

On appeal, the Federal Court of Appeal ("FCA") held that the TCC had made a palpable and overriding error in concluding that the Manager delegated a management or administrative service to FundCo, given that, in its view, the service provided to the Funds was in the nature of a financing service commonly provided by financial institutions. Thus, there was **no imported taxable supply** on which the Funds were obliged to self-assess GST. (para. 37)

Notwithstanding this conclusion, the FCA disallowed the rebate applications that the Manager had filed for the period from February 1, 2007 to June 30, 2010. This aspect of the ruling was based on exclusions provided for under paragraphs 261(2)(a) and (b) of the ETA that deny the right to obtain a rebate where assessments have been issued by the tax authorities. As stated by the FCA:

"The rationale for the exclusion presumably is that taxpayers are able to appeal assessments through notices of objection and it is not appropriate to provide another appeal mechanism through rebate applications." (para. 75)

The remainder of this section looks at the FCA's reasoning in more detail, with respect to the finding that there was no imported taxable supply and also with respect to the denial of the rebate applications.

Imported taxable supply

The FCA first stated that the TCC had not made an overriding error in concluding that there was a supply, as opposed to a service of providing money. (para. 38)

The second issue was whether the TCC had erred in deciding, effectively, that the Funds did not receive a "financial service" as defined under the ETA. As the TCC pointed out, one first must examine whether there was a single supply made to the Funds and what was the dominant element of such single supply. The FCA's analysis of this second issue was as follows:

- The FCA agreed with the TCC that the three main services provided to the Funds were:

    1. arranging for the payment of funding amounts;
    2. depositing the funding amounts; and
    3. providing funding notices to Citibank;

and that these three elements formed a **single supply with the daily payments of money as the dominant element**. (para. 41)

- The FCA concluded that FundCo clearly supplied a service of "arranging for" the payment of the funding amounts, which is a "financial service" as described in paragraph (l) of the definition of "financial service" in the ETA. (para. 44)

The third issue for the FCA was whether the TCC had made an error in concluding that service was ultimately taken outside the scope of the definition of "financial service" by being excluded under paragraph (q) as a "management or administrative service". (para. 45)

The FCA found a palpable error when the TCC concluded that the payment of commissions, even though integral to the day-to-day business and operations of the Funds, constituted management duties that were delegated by the Manager to the Citibank group. Although it was undoubtedly true that, under securities regulations, the Manager had a duty to ensure that the Funds were operating properly, it did not follow that the Manager was required to personally provide every service that the Funds might need. Therefore, when the Funds entered into the funding agreement with FundCo, the services regarding the new funding arrangement were not services required to be supplied by the Manager (the Funds actually took full responsibility in this respect). Furthermore, even if the Funds did not have any employees, they still had officers and trustees with the authority to act on their behalf. (para. 50)

The FCA found another overriding error in the form of the TCC's having considered it relevant that the Manager had previously funded the commissions. This fact, in and of itself, was not relevant; prior relationships that the Funds may or may not have had with the Manager should not have been taken into consideration when trying to assess an agreement with a different party. (para. 59)

Finally, the FCA expressly confirmed that the "management or administrative service" exclusion in paragraph (q) of the definition of "financial service" in the ETA is aimed at circumstances where GST/HST is avoided by having a manager unbundle its services and provide strictly financial services under a separate agreement. In the FCA's view, this "anti-avoidance rule" is not designed to apply when a person who is not providing managerial services provides a financing service, as was the case for FundCo. As a result, the exclusion in paragraph (q) did not apply and the Funds received an exempt supply of a financial service by FundCo. (para. 71)

Rebate claims

The rebate claims were filed under subsection 261(1) of the ETA. This provision allows for a rebate to be claimed for GST/HST that is remitted to the tax authorities whether by mistake or otherwise. However, the Crown argued that the rebate applications should be disallowed based on specific exclusions in paragraphs 261(2)(a) and (b) of the ETA. In a nutshell, these exclusions are supposed to preclude a taxpayer from claiming a rebate if a formal assessment was issued by the tax authorities with respect to the claimed amount. In other words, the proper appeal mechanism in a case like this would be to file a notice of objection, not a rebate application.

Unfortunately for the Funds, the Manager should have filed a notice of objection to preserve the right to recover the tax, which was not done after the CRA issued the assessments for each relevant tax period. Therefore, the FCA disallowed the Manager's rebate applications filed for the period from February 1, 2007 to June 30, 2010.

Takeaway

The decision provides interesting potential planning opportunities for investment plans and funds in terms of "unbundling" services currently rendered by a fund manager to reduce GST/HST leakage.

Although it seems clear that the ETA would not permit a fund manager to unbundle its services and provide a mix of financial and non-financial services under separate agreements, it now appears to be possible to enter into separate agreements with a third party – such as a financial institution – that does not otherwise supply managerial services to the investment entity, to "delegate" certain pure financial services that are normally provided by the fund manager. Any such agreements would of course require careful attention to the particularities of the specific situation involved.

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