

August 2018

## Finance Proposes Amendments to Limit Holding Company – Input Tax Credit (“ITC”) Claims and Seeks Consultations on Further Possible Changes

### Purpose of the Proposed Amendments

In the February 27, 2018 Budget, the Federal Government announced that it “intends to clarify which expenses for the parent corporation that are in respect of shares or indebtedness of a related commercial operating corporation qualify for input tax credits.” While the jurisprudence had taken an expansive view of what expenses may qualify for ITCs, the Canada Revenue Agency (the “**CRA**”) maintained its restrictive administrative policy limiting the expenses eligible for ITC claims. It was anticipated that these pending amendments would harmonize the law with the CRA’s longstanding administrative policy. For more information about the existing ITC holding company rules and the Canadian Government’s intention to change these rules, refer to our two Tax Bulletins at [Accessing Input Tax Credits \(“ITCs”\) of Holding Companies and Partners and Structuring of Partnerships to Reduce GST/HST Costs](#) (released in June 2014) and [Budget 2018: Government Proceeds with “Investment Limited Partnership” GST/HST Measures and Holding Corporation Consultations](#) (released in March 2018), respectively.

## Comparison of Existing Rules with the Proposed Amendments

Exactly five months after the Budget notifying stakeholders of the Federal Government's intention to modify the ITC holding company rules, the Department of Finance on July 27, 2018 (the "**Announcement Date**") released proposed amendments (the "**Proposed Amendments**") to set out the specific conditions under which taxable acquisitions or imports of property or services by holding companies would be eligible for ITC claims prospectively.

Both under the existing rules and Proposed Amendments, in order to be eligible for ITC claims, the holding company must be a "registrant" (either registered, or required to be registered, for the GST/HST) and resident in Canada.

Under the existing rules, where a registrant, resident holding company is "related to" an operating company and the operating company is engaged exclusively in a taxable commercial activity, the holding company can claim ITCs to recover GST/HST payable on its costs or imports (inputs), to the extent that these inputs are acquired or imported by the holding company "in relation to" the shares or indebtedness of the operating company. Not surprisingly, in view of the Supreme Court of Canada jurisprudence that pre-dated the GST/HST legislation, the Courts have interpreted "in relation to" in this context very broadly.

## Proposed Amendments to Impose Specific Conditions to Determine ITC Eligibility

In order to counteract this jurisprudence, the Proposed Amendments limit the conditions under which ITCs would be allowed. Effective as of the Announcement Date, the Proposed Amendments specifically define what is meant by "an operating corporation" of a holding company in new ss. 186(0.1) of the ETA. Substantively, this defined term corresponds with the pre-Announcement Date requirements for an operating company.

Under the Proposed Amendments effective as of Announcement Date, for the purpose of determining a holding company's ITC claim, the holding company will generally be considered to have acquired or

imported property or services for use in the course of commercial activities and eligible for ITCs, to the extent that the conditions in paragraph (a), (b) or (c) of ss. 186(1) in the Proposed Amendments applies. These conditions for ITC eligibility in paragraphs (a), (b) and (c) are entirely new and restrict the availability of ITC claims.

Paragraph (a) is satisfied if the holding company acquires or imports the property or service for the purpose of either:

- i. the holding company disposing of, acquiring or holding the shares, or indebtedness, of the particular “operating corporation”; or
- ii. the particular “operating corporation” redeeming, issuing, converting or otherwise modifying shares or indebtedness of the operating corporation.

Paragraph (b) is satisfied if all of the following conditions are satisfied:

- i. the holding company acquires or imports the property or services for the purpose of issuing or selling shares or indebtedness of the holding corporation,
- ii. the holding company transfers the proceeds from the issuance or sale in (i) above to the operating corporation in exchange for the shares or indebtedness of the operating corporation, and
- iii. these transferred proceeds are for use by the operating corporation exclusively in the course of its commercial activities.

To illustrate how paragraph (b) operates in practice, the Department of Finance provided the following example in its Explanatory Notes for the Proposed Amendments. A holding company generates \$1,000,000 of proceeds from the issuance of bonds. The holding company acquires legal services for the purpose of issuing these bonds. Of the \$1,000,000 of proceeds raised from its bond issuance, the holding company distributes \$800,000 of the proceeds to an operating corporation of the holding company, of which \$750,000 is

used by the operating corporation to purchase equipment used exclusively in its commercial activities, and the balance of \$50,000 is invested in money market securities. In consideration for the \$800,000 payment to the operating corporation, the holding company acquires shares of the operating corporation.

Under the Proposed Amendments, the holding company would be deemed to have acquired 75% of the legal services for use in the holding company's commercial activities. By virtue of subparagraph (b)(ii), the potential ITC pool is limited to 80% of the legal fees, as only \$800,000 of the \$1,000,000 (80%) of the proceeds are transferred and made available to the operating corporation in exchange for common shares of the operating corporation. As \$50,000 is invested in money market securities (exempt financial services) and exempt supplies are generally carved out from commercial activities, the ITC pool is further limited by another 5% ( $\$50,000/\$1,000,000$ ) to 75% of the legal fees. Only 75% of the GST/HST payable on the legal fees relating to the bond issuance would be recoverable by ITC claims.

Had the existing rules applied, as interpreted by the Courts, at least 80% of the GST/HST payable on the legal fees would have been recoverable by ITC claims, as at least \$800,000 of the \$1,000,000 proceeds raised by the bond issuance are "in relation to" the shares of the operating corporation. That is a sensible result too, since for the purpose of determining the operating corporation's own ITC claims, taxable inputs acquired by the operating corporation for use in its exempt financial services (investing in money market securities) "that relate to" its commercial activities would normally be treated as part of its own commercial activities and eligible for ITC claims pursuant to ss. 185(1) of the ETA.

On the positive side, the Proposed Amendments in paragraph (b) are more liberal than the CRA's existing administrative policy. In one example in the published policy, a holding company issues shares of its own in order to purchase a further 15% of the shares of the operating corporation. The holding company pays GST/HST on the legal and accounting services acquired to issue the shares. As the legal and accounting services are acquired by the holding company to issue its own shares (the most direct or first order purpose), they are

not for consumption or use “in relation to” the shares of the operating company (the secondary or second order purpose). Accordingly, the CRA opines that no ITCs should be allowed to recover the GST/HST payable on the professional fees.<sup>1</sup> In stark contrast, the Courts have said that the phrase “in relation to” should be interpreted expansively, and the shares of the operating corporation need not be the direct purpose of the inputs acquired, but can be more remotely or indirectly connected to the inputs (such as a secondary purpose).

Under paragraph (c), provided that all or substantially all of the holding company’s property is shares or indebtedness of operating corporations, ITCs are available for taxable inputs acquired or imported for the purpose of carrying on an activity of the holding company, subject to the listed exclusions in subparagraphs (c)(i) and (ii). The first exception in subparagraph (c)(i) is for an activity that is *primarily* in respect of shares or indebtedness of a person that is neither the holding company nor one of its operating corporations. The second exception in subparagraph (c)(ii) is for an activity engaged in the course of making an exempt supply by the holding company, unless it is an exempt financial service that is listed in any of clauses (c)(ii)(A) to (E).

### Clarifying Amendments

Certain of the Proposed Amendments take effect prior to the Announcement Date. Among them, certain Proposed Amendments clarify that property of an operating corporation could be manufactured or produced (not only acquired or imported) for consumption, use or supply exclusively in the course of the corporation’s commercial activities. Effective as of Announcement Date, these amendments are incorporated into the definition of an “operating corporation” in ss. 186(0.1).

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<sup>1</sup> Example 3, page 6 of the CRA’s GST/HST Memorandum 8.6 – Input Tax Credits for Holding Corporations and Corporate Takeovers.

## Increased Complexity and Tracking of Inputs

Once again, where the jurisprudence has gone further in allowing tax relief than what the Federal Government believes is appropriate or intended, the Federal Government introduces amendments to override the jurisprudence (at least fortunately in this case not retroactively). The amendments are inevitably detailed and complex. In addition to being more restrictive than the existing rules, the conditions for ITC eligibility imposed under the Proposed Amendments add layers of complexity that introduce onerous obligations to trace how taxable inputs are used.

## Consultations

On July 27, 2018, along with the Proposed Amendments, the Government released a consultation paper. As announced in the 2018 Federal Budget, the Government is considering making the ITC holding company rules even more restrictive. The consultation paper discusses the Government's concern and what is under consideration to address this concern.

Currently, under the existing rules and the Proposed Amendments, it is sufficient that the holding company is "related to" the operating corporation. That test could be satisfied, for example, where the holding company owns 51% of the shares of the operating corporation and controls the operating corporation. The Federal Government is concerned that the threshold for the degree of integration between the holding company and operating corporation under the "related to" test is too low. The Federal Government is seeking consultations on whether to raise the relationship threshold to closely-related, like for certain other tax relieving provisions (generally, there is at least 90% common ownership among the corporations).

Conversely, the Government is also seeking consultation on liberalizing the ITC rules, so as not to discriminate against other investment vehicles, such as partnerships and trusts. The Government has concerns with whether the degree of ownership or control of a partnership or a trust may be as readily determined as with corporations. In this regard, the "Government is interested in

hearing stakeholders' views regarding expanding the holding corporation rule to include partnerships and trusts, given the issues described above for determining a partnership's or trust's proxy for voting rights."

By September 28, 2018, parties may submit comments in writing to the Department of Finance on either or both of the above topics under consideration.

by [Jamie M. Wilks](#)

For more information on this topic, please contact:

Toronto      [Jamie M. Wilks](#)      416.865.7804      [jamie.wilks@mcmillan.ca](mailto:jamie.wilks@mcmillan.ca)

#### [a cautionary note](#)

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