mcmillan advisory

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significant proposed HST changes for funds and their managers

client advisory

purpose

On May 19, 2010, the Department of Finance ("**Finance**") released proposed rules for determining the ultimate HST liabilities of funds (among other types of "listed financial institutions" ("**LFIs**")). The proposed rules are intended to remove any incentive for funds or their investment managers to re-locate to provinces without HST. In essence, the ultimate burden of the provincial portion of the HST ("**PVAT**") levied on funds is based on the residence of investors rather than on where goods or services are sourced, received or performed.

scope of application

The proposed rules apply to LFIs, including:

a. investment plans, which include registered pension plans, employee benefit plans, unit trusts, pooled fund trusts and mutual fund trusts ("**MFTs**"), and

b. segregated funds of insurers,

where these entities (collectively, "**Included Funds**") have permanent establishments (i.e., offices) or investors (or beneficiaries, as applicable) in either a combination of non-HST and HST provinces or different HST provinces.

Such Included Funds come within the proposed amended definition of "selected listed financial institution" ("**SLFI**"). Under the amended SLFI test, an Included Fund would be an SLFI throughout a GST/HST reporting period if the Included Fund meets the foregoing test at any time in a particular fiscal year that includes the reporting period. By design, a small investment plan with unrecoverable GST of less than $10,000 in its preceding year is excluded from the definition of SLFI and is instead subject to the general self-assessment and rebate rules for the PVAT.

Notable by their absence are investment funds that are structured as partnerships (which are not considered LFIs). We understand that this omission by Finance may have been an unintentional oversight and that Finance will likely expand the scope of the proposed amendments to extend to such funds.

Special Attribution Method (SAM) and Provincial Attribution Percentage (PAP)

As an SLFI, an Included Fund would need to annually calculate its appropriate PVAT burden. Under the SAM formula, the unrecoverable GST (GST paid in excess of its input tax credit ("**ITC**") claims) is grossed-up by a factor to reflect the PVAT rate in a particular HST province,

multiplied by the appropriate PAP for the province (described below). SLFIs need to track GST and PVAT payable/paid separately for each HST province.

As the SAM formula is intended to take into account eligible ITC and rebate claims in respect of PVAT, SLFIs do not specifically claim ITCs or rebates. The PVAT actually paid for the province is subtracted/credited under the SAM formula. If the SLFI has underpaid PVAT during the year in accordance with SAM, additional PVAT is owing. If SLFI has overpaid PVAT during the year in accordance with SAM, the SLFI is entitled to a net refund of PVAT on the difference.

The PAP depends on the particular type of SLFI. For a MFT, PAP is determined by reference to each **series** of fund units. The formula applied to calculate the PAP for a specific **series** is as follows:

$$\frac{\text{Value of units held by unit holders } \textbf{resident in HST province}}{\text{Value of units held by unit holders } \textbf{resident in Canada}}$$

Under the above PAP formula, f**oreign unit holders (not resident in Canada) are disregarded**.

In the case of an institutional investor that is a SLFI, an Included Fund would have to “look through” the institutional investor to determine the value of investments held by individuals through the institutional investor and the residence of these individuals. The institutional investor would generally be required to provide this information to the Included Fund. This information could be the PAP of the institutional investor. To obtain this information, the institutional investor may need to look through its own institutional investors. There will be penalties for failure to provide information in a timely manner.

The following simple examples illustrate how the SAM and PAP would operate in the case of a MFT. An Alberta MFT has one series of units with 30% of the value of the units held by investors in Alberta and the remaining 70% of the value owned by investors in Ontario. The Alberta investment manager charges $1 million in fees, plus 5% GST of $50,000, in a particular fiscal year. (Under the amended provincial place of supply rules for services, the investment manager is considered to supply its services in the province of Alberta, a non-HST province, and, therefore, charges and collects the 5% GST).

Under the proposed HST SLFI amendments, the MFT would have an Ontario PVAT liability of $56,000 (being 70% of the unrecoverable GST, assuming that the MFT cannot claim any ITCS, multiplied by 8/5, i.e., the Ontario PVAT rate over the 5% GST rate). This example assumes that the MFT’s only taxable input during the year is the investment manager’s fees.

In the next example, assume that both the MFT and the investment manager are located in Ontario. Under the amended provincial place of supply rules for services, the investment manager is considered to supply its services in Ontario and is, therefore, required to charge and collect the 13% Ontario HST of $130,000, of which $80,000 is PVAT, on its $1 million annual fees (in the absence of a "transfer tax" election, discussed below). As discussed above, under SAM, the MFT's Ontario PVAT liability for the year is equal to $56,000. Therefore, the Ontario MFT is entitled to a net PVAT refund of $24,000 ($80,000 - $56,000, the extent of the overpayment of Ontario PVAT by the MFT as determined under SAM). In practice, if the MFT makes a "transfer tax" election (discussed below), it may be able to reduce its initial HST liability to the extent that it would otherwise receive a subsequent PVAT refund under SAM.

application of PAP

PAP would be calculated as of September 30 each year. It can either reflect the PAP on that particular date (September 30), or be an annual average, with September 30 as the end-date for the 12-month period. The annual average can be based on quarterly, monthly, weekly or daily percentages during that 12-month period. To do the latter (using an overall average for the year), the Included Fund would have to make an election in the prescribed form containing prescribed information. The election would remain in effect until either revoked or an election is made to use another method. To revoke the election, it must have been in effect for a minimum period of at least three years. As a condition of making this election, the Included Fund must have information on the location of investors holding all or substantially all (generally 90% or more) of the value of units (after the look-through, to the extent needed) for a particular series of units or class of shares, as applicable.

There are three methods for determining PAP for a year. Under the proposed **General Rule (with reconciliation)**, the Included Fund would be allowed to use the PAP calculated with preceding year's values (as of September 30 of the preceding year) to estimate PVAT instalments for the current fiscal year, with a reconciliation on the final SLFI return using the current year's values and PAP (as of September 30 of the current year) under the SAM. Since the final SLFI return would not be due until six months until after the end of the fiscal year, the Included Fund would have time to gather the information to calculate the SAM using the current year's values and PAP. Depending on whether or not the instalments exceed, or are less than, the actual PVAT liability under SAM, the Included Fund could be entitled to either a refund or owe PVAT with the final SLFI return for the year.

Alternatively, an Included Fund can elect to use the preceding year's PAP and values (as of September 30 of the preceding year) without having to do a reconciliation, known as the **Preceding Year Method (without reconciliation)**. Alternatively, where

more than 90% of the value of the units or shares of a particular series or class, as the case may be, are held by retail investors, then the Included Fund can elect to use the Real Time Method. No look-through rules would apply under the Real Time Method. Under this Method, an Included Fund could elect to determine its PAP for a HST province based on the location of unit holders determined either on a daily basis or the first day of each month. For all three PAP methods, an Included Fund is required to obtain investor information (either directly or using the look-through rules) for investors holding 90% or more of the value of the series or class. To the extent that sufficient investor information cannot be obtained, the unallocated portion would, by default, be automatically allocated to the HST province with the highest HST/PVAT rate.

filing, reporting and remittance elections

For administrative convenience, an election can be made to allow a fund manager to file the annual SLFI GST/HST return on behalf of an Included Fund. A second election could be made to allow the fund manager to file a single consolidated GST/HST SLFI return for all Included Funds on whose behalf the manager can file returns. A single GST/HST registration number would be assigned to all the Included Funds to allow consolidated reporting and filing, relieving each Included Fund of the obligation to separately register for the GST/HST.

Another election, known as a “transfer tax” election could be made to alleviate the cash flow burden on an Included Fund, which would arise from the fund manager collecting HST throughout the year on its fees and the Included Fund having to wait until after the year to receive any net PVAT refund to which it may be entitled under SAM. The election could also be beneficial if the fund manager collects GST throughout the year on its fees and the Included Fund would have a significant PVAT liability (cash payment) after the year resulting from the application of the SAM formula.

In the first instance where the Included Fund would be eligible for a net PVAT refund, the fund manager would be required to credit/refund the PVAT amount to the Included Fund and remit the net PVAT collected with the 5% GST (rather than the full HST on the manager’s fee) with its applicable GST/HST return. In the second instance, this election would allow the fund manager to collect the net PVAT liability of an Included Fund (in addition to, rather than just, the GST on the manager’s fee) and remit the net PVAT liability with the GST on its own GST/HST return.

other considerations

The proposed rules contain a number of special rules and transitional rules. For example, it is proposed that there be special rules for determining the PAP for

Exchanged Trade Funds ("**ETFs**") to take into account that, since they are exchange traded daily, the composition of investors may be changing daily and limited investor information may be available.

Since BC and Ontario will implement HST effective July 1, 2010 (in the middle of a year), there is a prorating formula for BC and Ontario PAP proposed to apply for a transitional reporting period of an Included Fund that begins before, and ends on or after, July 1, 2010. There are a number of additional transitional rules proposed for 2010.

Planning and structuring opportunities may exist to lessen the overall HST burden on Included Funds and/or specifically on individual investors. For example, the investment manager may consider contracting separately with each investor and thereby relieve non-resident investors from any tax burden and investors in non-HST provinces from any PVAT burden. The result may be that the investors in the participating HST provinces bear the full brunt of the HST costs (as some might argue they should). There is also the possibility of having a unique series or class for investors in each province, or for investors in HST provinces and non-HST provinces. All of which is to say that the interests of all parties need to be taken into account and balanced against the administrative and practical compliance realities and costs. One certainty is that Included Funds and their managers will need to look closely at the proposed rules and carefully consider their available options for complying with these complex rules. One additional cautionary note: the actual law to implement the new SLFI HST regime has not yet been released by Finance and it remains to be seen how the details will be reflected in the law.

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