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Indirect Tax Alert

News from Americas Tax Center

Finance Canada releases draft amendments and proposals for ETA section 186 holding corporation rules

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Executive summary

On 27 July 2018, Canada's Department of Finance released a package of draft legislative proposals and explanatory notes relating to a number of measures announced in the 2018 federal budget,¹ including draft amendments to the holding corporation rules contained in section 186 of the *Excise Tax Act* (ETA or the Act). These amendments would broaden the "commercial operating corporation property test" that an operating corporation must meet for the parent to benefit from the holding corporation rules and also specify certain circumstances under which the parent can claim an input tax credit (ITC).

On the same date, the Government released a consultation paper on two potential changes to the Goods and Services Tax (GST)/Harmonized Sales Tax (HST) holding corporation rules: namely, tightening the "common ownership" benchmark by requiring a parent corporation and an operating corporation to be closely related rather than related, and extending the application of the holding corporation rules to include partnerships and trusts.

Interested parties are invited to provide comments on the legislative proposals relating to holding corporations by 10 September 2018, and on the consultation paper by 28 September 2018.

Detailed discussion

Background

Section 186 of the Act provides that where a registered Canadian corporation (the parent corporation) holds shares or debt of a related corporation that is exclusively (90% or more) engaged in commercial activities at the time GST/HST becomes payable on costs incurred in holding or administering the shares or debt, the parent corporation is deemed to have incurred those costs in the course of its commercial activities. Therefore, the parent may recover the tax as an ITC.

More specifically, the rules apply where:

- ▶ A parent corporation acquires, imports or brings into a participating province a property or service that can reasonably be regarded as having been acquired, imported or brought into the province for consumption or use in relation to the shares or debt of a related corporation.
- ▶ The related corporation last acquired or imported all or substantially all (90% or more) of its property for consumption, use or supply exclusively in the course of its commercial activities.

In accordance with subsection 186(2), a corporation may also claim ITCs in respect of takeover fees incurred in acquiring or attempting to acquire all or substantially all the voting shares of a corporation engaging exclusively in commercial activities.

Legislative proposals

Finance Canada proposes to amend the holding corporation rules in two ways.

First, it would broaden the “commercial operating corporation property test” that a related corporation (designated as an “operating corporation” by the amendments) must meet for the parent to benefit from the holding corporation rules, by including property that was last manufactured or produced by the operating corporation. Similar amendments would apply to the commercial operating corporation property test found in subsection 186(2) of the Act in relation to takeover fees, the interpretative rule of subsection 186(3) of the Act, and the optional GST/HST registration rule in paragraph 240(3)(d) of the Act.

These amendments address the issue raised in a 22 January 2018 comfort letter, in which the Canada Revenue Agency acknowledged that the lack of a reference to property that was “manufactured or produced” in the commercial operating corporation property test could prevent a parent corporation from claiming ITCs in otherwise appropriate circumstances.

The proposed amendments would also specify certain circumstances under which the parent corporation can claim an ITC under the holding corporation rules for expenses it incurred.

A parent corporation would be deemed to acquire a property or service in the course of its commercial activities (allowing it claim an ITC) where it acquired or imported the property or service, or brought it into a participating province, for the purpose of:

- ▶ Enabling the parent to sell, purchase or hold shares or debt of the operating corporation; or
- ▶ Enabling the operating corporation to redeem, issue, convert or otherwise modify its debt or shares of its capital stock.

A parent corporation could also claim an ITC in respect of a property or service where:

- ▶ The parent acquired, imported or brought the property into a participating province in order to issue or sell shares or debt of the parent.
- ▶ The parent transferred the proceeds from the issuance or sale to the operating corporation by lending it money or by acquiring the operating corporation’s shares.
- ▶ The operating corporation uses the proceeds exclusively in the course of its commercial activities.²

New paragraph 186(1)(c) would apply where 90% or more of the property of a parent corporation is shares or debt of its operating corporations. In this instance, the section 186 deeming provisions would apply where a parent acquired, imported or brought a property or service into a participating province for the purpose of carrying on, engaging in or conducting an activity of the parent, other than:

- ▶ An activity that relates primarily to shares or debt of a person other than the parent or the operating corporation; or
- ▶ An activity that is carried on, engaged in or conducted in the course of making an exempt supply by the parent.

However, the exclusion of exempt supplies made by the parent would not apply to the following financial services:³

- ▶ The lending or borrowing of shares or debt of an operating corporation of the parent
- ▶ The issue, granting, allotment, acceptance, endorsement, renewal, processing, variation, transfer of ownership, or repayment of shares or debt of the parent or an operating corporation of the parent

- ▶ The provision, variation, release or receipt of a guarantee, acceptance or indemnity in relation to shares or debt of the parent or an operating corporation of the parent
- ▶ The payment or receipt of money as dividends (other than patronage dividends), interest, principal, benefits or similar receipt or payment of money in relation to shares or debt of the parent or an operating corporation of the parent
- ▶ The underwriting of shares or debt of an operating corporation of the parent

If enacted, the amendments to the holding corporation rules would apply to any acquisition, importation or bringing into a participating province of property or a service after 27 July 2018.

Consultation paper

In addition to the legislative proposals, Finance Canada released a consultation paper on 27 July 2018, seeking input on two proposals in relation to the holding corporation rules.

First, Finance is proposing to replace the requirement that the parent corporation and the commercial operating corporation be related (i.e., one corporation controls the other corporation) with a requirement that they be closely related, meaning there is at least 90% common ownership among the corporations. In general, a person may not

claim ITCs for investments in the shares or indebtedness of another person, as raising capital is an exempt financial service. Finance views the exception provided under section 186 as warranted where the parent corporation and operating corporation effectively operate as a single entity. The concern is that there are situations where related corporations may not effectively constitute a single entity; for example, where a parent corporation has a 51% interest in a commercial operating corporation.

Second, it is considering whether to extend the application of the holding corporation rules to include partnerships and trusts, on the basis such entities may effectively function as parent corporations. Generally, there is no GST/HST policy basis for preferring one business structure over another. The current rationale for restricting the GST/HST group relief or look-through rules to corporations is that determining whether corporations are related or closely related is relatively straightforward; one simply counts the voting rights attached to a corporation's shares. Making such determinations in respect of partnerships and trusts is not so straightforward, as voting rights generally do not come into play. As one potential solution, Finance suggests that the value of a partner's interest in a partnership could be used as a proxy for voting rights.

Interested parties may provide comments on the consultation paper by 28 September 2018.

Endnotes

1. See EY Global Tax Alert, [Canada issues federal budget 2018-19](#), dated 1 March 2018.
2. Finance Canada provides the following example for the application of amended paragraph 186(1)(b). A parent corporation acquires legal services for the purpose of issuing bonds and uses the generated funds to purchase shares of an operating corporation of the parent. The operating corporation uses the proceeds from the sale of its shares to acquire equipment for exclusive use in its commercial activities. The parent may claim an ITC in respect of GST/HST paid for the legal services.
3. For example, a parent corporation acquires a computer, and 80% of its use relates to exempt supplies of residential units, while the remaining 20% relates to the payment of dividends to its shareholders. The parent could not claim an ITC for the computer to the extent the computer's usage relates to exempt supplies of residential units. However, the parent could claim an ITC for 20% of the GST/HST paid for the computer, since that portion relates to one of the financial service exceptions (i.e., paying dividends).

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