



Pension Investment
Association of Canada

Association canadienne des
gestionnaires de caisses de retraite

September 21, 2018

Sales Tax Division
Tax Policy Branch
Department of Finance
90 Elgin Street
Ottawa, Ontario K1A 0G5
Via Email: fin.gsthst2018-tpstvh2018.fin@canada.ca

Dear Sir/Madam,

Re: Legislative and Regulatory Proposals Relating to the Goods and Services Tax/Harmonized Sales Tax and Consultation Concerning the GST/HST Holding Corporation Rules

The purpose of this letter is to provide comments from the Pension Investment Association of Canada (“PIAC”) on the Draft Tax Legislative Proposals for the GST/HST holding corporation rules and the consultation paper “Consultation Concerning the GST/HST Holding Corporation Rules” released on July 27, 2018. As part of a balanced investment strategy, pension plans utilize holding company structures, thus making the impact of any GST/HST on investment returns a matter of great importance. We appreciate the opportunity to be a part of this consultation process and we look forward to further consultation on the matters we raise in this letter.

PIAC has been the national voice for Canadian private and public pension funds since 1977 in matters related to investment and governance. Senior investment professionals employed by PIAC’s member funds are responsible for the oversight and management of over \$2 trillion in assets on behalf of millions of Canadians. PIAC’s mission is to promote sound investment practices and good governance for the benefit of pension plan sponsors and beneficiaries. PIAC’s positions on public policy reflect the fiduciary framework in which member funds operate and its commitment to work in the best interests of plan members.

PIAC believes the government of Canada should, in considering tax policy affecting pension plan investments, take into account that pension plans play an important role in Canadian society and the economy. PIAC’s membership invests contributions made by

employees and employers to provide secure, stable retirement income for working Canadians.

Executive Summary

All references unless otherwise noted are to the Excise Tax Act.

- PIAC is concerned that the proposed legislative changes to section 186 will result in the denial of input tax credits (ITCs) that are currently available to pension plans that utilize holding corporation structures and believes that the proposed legislative changes should not go forward unless the scope of the relief under existing section 186 is maintained.
- PIAC is supportive of the suggestion in the consultation paper to extend the application of section 186 to include partnerships and trusts.
- PIAC does not support the suggestion in the consultation paper to replace the existing “related” test in section 186 with a “closely related” test. It believes such a change would mark a departure from the original policy objective of section 186 and create material inequities and non-neutralities between different pension plan structures.

Below, please find commentary on the draft legislative proposals and the consultation paper.

Draft Legislative Proposals relating to Section 186 of the Excise Tax Act

Section 186 allows registrants investing in related corporations that are engaged in commercial activities to claim ITCs in respect of expenses relating to the shares or indebtedness of those corporations or related corporations.

Current Rules are Broad

The current rules in section 186 allow a holding corporation to claim ITCs for GST/HST paid on property and services it acquires if it can be reasonably considered that the property or services are in relation to the shares or indebtedness of another corporation related to the holding corporation. A number of other conditions must also be met, including a requirement that all or substantially all of the property of the other corporation is for consumption, use or supply in the course of its commercial activities. The CRA has taken a narrow interpretation of these rules over the years resulting in a number of court cases. The courts in turn, have generally taken a broader view.

Proposed Amendments Reduce Scope of ITCs

The draft legislative proposals to amend section 186 significantly change the current rules. Among other things, the “reasonably be regarded” and “in relation to” tests, which are broad and allow flexibility, are proposed to be replaced with prescriptive, apparently more

restrictive provisions that list specific activities and circumstances that may allow a holding corporation to claim ITCs. We are concerned that the proposals will narrow the scope of ITCs that are currently available to holding corporations.

We have particular concerns with the phrase “for the purpose of holding shares” in proposed subparagraph 186(1)(a)(i). It is not clear what types of expenses would be captured by this phrase and suggest that Finance Canada clarify its intent by providing examples of the types of expenses it would consider as qualifying for relief.

Where the specific purpose tests in paragraphs (a) and (b) are not met, the draft legislative proposals would also introduce a new “property test” for holding corporations under paragraph (c) as an alternate path to ITCs. In order to meet this new “property test”, all or substantially all of the property of a holding corporation must be shares or debt of related operating corporations. A holding corporation that carries on other activities or that owns shares of other corporations, in addition to owning shares of related operating corporations, may not meet the new property test included in the proposals and as a result may not be eligible to claim ITCs.

PIAC appreciates that the proposed changes attempt to codify past jurisprudence and may result in a more consistent application and interpretation and in this respect are intended to clarify the application of section 186 rather than narrow its scope.

PIAC is concerned however, that the proposed prescriptive approach and the introduction of new purpose and property tests will unintentionally result in some holding corporations being denied ITCs for which they may qualify under the existing provisions.

Example of Impact

An example would be where a pension corporation owns two subsidiaries of equal value, a real estate corporation and an investment corporation, and the pension corporation incurs expenses related to the management and oversight of its two subsidiaries. The real estate corporation is engaged exclusively in the operation of a commercial real estate business and meets the current property test in existing paragraph 186(1)(b). The investment corporation invests in financial instruments and does not meet the property test.

Under existing subsection 186(1), the pension corporation is entitled to claim ITCs on GST/HST paid on its expenses to the extent they relate to its portfolio investment in the real estate corporation, applying general principles of allocation.

However, under proposed subsection 186(1), this ITC entitlement may no longer be available as the expenses would not appear to meet the specific purpose tests in either of proposed paragraphs (a) or (b) or the property test in (c). Indeed, the pension corporation would not appear to meet the test in paragraph (a) as the expense is not for the specific purpose of holding shares of the real estate corporation but rather in respect

of the broader activities of the pension corporation, which exists in order to hold the shares of its two subsidiaries. In addition, the pension corporation would not appear to meet the property test in proposed paragraph (c) due to its holding of the shares of the investment corporation.

A variant of this example may be where the pension corporation holds some assets directly (other than shares or debt of related operating corporations) and thereby fails the property test in proposed paragraph (c) by virtue of its directly held assets, whether or not those assets are used in commercial activity.

Limited Alternatives

We also note that in some industry sectors, parent corporations may have the option to charge taxable management fees to their subsidiary corporations, which would allow the parent to claim ITCs on expenses related to the management fees without reliance on section 186. Pension corporations however, are subject to regulatory restrictions on their activities (such as income tax and pension law restrictions on non-investment income and US tax restrictions on the provision of services) that generally prevent them from charging management fees and are therefore more reliant on section 186.

PIAC's Concern

By denying ITCs that are currently available under existing section 186, the draft legislative proposals would increase the cost of holding assets through a holding company for some corporate structures and result in reduced investment returns for the benefit of Canadian pensioners.

We believe that this result is not consistent with the original policy intent of section 186, which was to achieve greater neutrality between holding structures. It is common for pension plans to hold commercial activity assets through subsidiaries for a variety of legal, regulatory and commercial reasons, and the decision to hold assets in this manner should not be swayed by GST/HST considerations.

We understand that the goal of the holding company rules is to facilitate the use of holding company structures in these circumstances such that the GST/HST result achieved is equivalent to that which would be realised where an asset is held directly. The proposed legislation prevents this.

We are also concerned that, in addition to narrowing the scope of ITCs available, the multiple purpose tests, property tests and carve outs contained in the proposed legislation increases the complexity of the holding company rules, thereby potentially undermining the greater certainty that we understand Finance is aiming to provide.

We therefore recommend that Finance Canada not proceed with the legislative proposals until the concerns identified above are addressed and the scope of the relief under the

existing provisions of section 186 is maintained, as well as extended to partnerships and trusts as discussed below.

Consultation Concerning the GST/HST Holding Corporation Rules

The consultation paper released on July 27, 2018 seeks comments on two other possible changes to the holding corporation rules: replacing the current “related” test with a “closely related” test and expanding the rules to include partnerships and trusts.

Related Test

Existing section 186 requires a parent corporation and commercial operating corporation to be related which generally means more than 50% common ownership. The consultation paper suggests that the related test be replaced with a closely related test which generally means at least 90% common ownership. The rationale given in the consultation paper for this change is that the “closely related” test would strengthen the rule and ensure that it does not lead to inappropriate policy outcomes.

As noted in the consultation paper, the relief provided under section 186 is an exception to the principle that investment by a person in the shares or indebtedness of another person is an exempt financial service for which input tax credits cannot be claimed. The justification for allowing the parent corporation to claim ITCs in the circumstances meeting the conditions of section 186 is that the related parent and commercial operating corporation effectively operate as a single entity.

PIAC has concerns with replacing the “related” test with a “closely related” test as it would unduly restrict the application of section 186 and negatively impact those of its members who utilize holding company structures in which more than 50% but less than 90% of shares of a commercial operating corporation are held by the holding corporation.

For example, it is common for assets to be held alongside co-investors who would typically have greater than 10% ownership in order to diversify risk and benefit from the commercial expertise of co-investors who have a significant common economic interest in a business. The shift from a “related” to a “closely related” test would potentially exclude PIAC members’ co-investments in commercial activity assets from relying upon the holding company rules.

It is not clear why the existing rules need to be “strengthened” as suggested in the consultation paper by replacing the “related” test with a “closely related” test. The existing “related” test has been used since the introduction of the GST and meets the policy objectives of section 186. While non-neutralities may arise, as noted in the discussion paper with the example of a corporation which owns less than 50% of the shares of an operating corporation, these non-neutralities are due to the exempt treatment of financial services under the GST. Exemption under any VAT will create some degree of non-

neutralities. While replacing the “related” test with a “closely related” test may address the specific non-neutrality identified in the discussion paper, it would create other, more significant non-neutralities between holding corporation structures in which corporations are related and those in which corporations are closely related.

In addition to the “single entity” concept, we believe a further policy rationale for the “related” test is to distinguish between more passive investors with minority ownership, and more active investors with majority ownership, who by virtue of having control, necessarily have a material role in directing the business of the operating company, such that it is appropriate for related costs to be relieved of HST. In our members’ experience, the degree of involvement by a parent corporation in directing the activities of a related subsidiary corporation is essentially the same as with a closely related subsidiary corporation.

PIAC is of the view that the existing “related” test which requires effective control of other corporations meets the policy objective of corporations effectively operating as a single entity. We would therefore not support replacing the existing test with a “closely related” test.

Partnerships and Trusts

The consultation paper also seeks comments on extending the current scheme of section 186, which is limited to corporations, to include partnerships and trusts.

PIAC has advocated for this change in the past and is strongly supportive. Its membership makes extensive use of trusts and partnerships and extending section 186 to include other corporate structures would result in greater equity and neutrality between pension plan structures.

It is not entirely clear from the consultation paper whether the suggestion is to extend the holding company rules to situations where a partnership or trust holds shares in a corporation as well as situations where a parent corporation holds controlling interests in a partnership or trust. PIAC members use partnerships and trusts in both situations and recommend that both situations be included.

We are concerned however, that the benefits of greater neutrality arising from such an extension would be greatly diminished if the “related” test is replaced with a “closely related” test, as well as if the proposed amendments to the ITC rules are implemented without revision.

The consultation paper highlights the challenges in valuing a partner’s or beneficiary’s interests in order to determine whether parties in a structure that includes partnerships or trusts are related.

In this regard, we believe that subsection 156(1.3) may provide some guidance on how to address this challenge with respect to partnerships. While the test in subsection 156(1.3) is a “closely related” test, it could be adapted to the section 186 context by replacing “at least 90%” with “greater than 50%”. We believe that the concepts utilized in subsection 156(1.3) (i.e. entitlement to receive income/distribution of assets and ability to direct the business) could also be adapted to trusts.

The Income Tax Act may also provide some guidance with respect to trusts. For example, where a trust owns a majority of the voting shares of a corporation such that the trustee(s) of the trust control the corporation, the trust and the corporation will be related persons by virtue of subparagraph 251(2)(b)(i) of the Income Tax Act.

We would also note that many pension plans are organized as trusts which hold wholly owned subsidiary corporations. In these circumstances the fact that the trust holds the shares of the subsidiary corporation makes it clear that the trust and its subsidiary corporations are related; as such in this case there is no need to determine who owns or controls the trust.

Similarly in the inverse scenario where a partnership or trust is wholly owned by members of a related party group, this should simplify the determination that said partnership or trust is related to the members of the related party group and should obviate the need to perform a valuation of the partnership or trust interests.

Conclusion

PIAC appreciates the opportunity for ongoing dialogue with the Department of Finance Canada on this matter. We believe the role PIAC members play as both investors in the Canadian economy and as the providers of retirement income support to Canadians warrants a significant level of transparency and dialogue in advance of any changes being made.

Given the concerns with the proposed legislative changes to section 186 discussed above, we would recommend that the draft legislation be revised to take into account these concerns and that the revised draft legislation be released for further consultation. We further suggest that Finance Canada clarify its intent by providing additional examples of the types of expenses it would consider as qualifying under any proposed legislative changes.

We also believe that should the Department of Finance Canada decide to proceed with either or both of the proposals in the consultation paper, draft legislation be released for consultation.

As any changes to section 186 will impact Canadian pension plans, we would welcome an opportunity to meet with Department of Finance Canada officials to elaborate on our concerns and comments and to answer any questions they may have.

Please do not hesitate to contact us if you wish to discuss any aspect of this letter in further detail.

Yours sincerely,

A handwritten signature in blue ink that reads "Brenda King". The signature is written in a cursive, flowing style.

Brenda King
Chair