

When One Taxpayer Wins, We All Lose: GST/HST on Asset Management Services

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The federal budget that was released on March 4, 2010 contains draft legislation to implement the proposed changes to the definition of “financial services” in the *Excise Tax Act* (Canada) (ETA) previously announced on December 14, 2009 (the Proposals).

As stated in the backgrounder to the Proposals, the proposed changes respond to several court cases in which the taxpayers successfully argued that services containing some elements of advice and/or administration were exempt financial supplies.¹ The Proposals had been widely expected given the Department of Finance’s historical practice regarding GST/HST matters. What was not expected was that the Canada Revenue Agency (CRA) would take the view that contrary to its own longstanding administrative policies and practice, trailer commissions, front-end load commissions, deferred sales charges and redemption fees became subject to GST/HST effective December 15, 2009 as a consequence of the Proposals.

As is the normal practice with ETA amendments, the draft legislation implementing the Proposals is deemed to be effective on December 17, 1990, the day that the GST legislation came into force. The changes, however, will apply to an “asset management service” (defined below) rendered under an agreement for a supply if (i) any consideration for the supply becomes due or is paid after December 14, 2009 or (ii) all the consideration for the supply became due or was paid on or before December 14, 2009 unless the supplier did not, on or before that day, charge, collect or remit any amount as or on account of tax in respect of the supply or in respect of any other supply that includes an asset management service and that is made under the agreement.

The draft legislation contains a broad new definition of an “asset management service,” which is to be excluded from the definition of financial services. Under this new definition, an “asset management service” comprises services (other than a prescribed service) rendered by a particular person in respect of the assets or liabilities of another person, including activities such as:

¹ These cases notably include *Canadian Medical Protective Assn. v. The Queen*, [2009] G.S.T.C. 65 (F.C.A.); *Costco Wholesale Canada Ltd. v. The Queen*, [2009] G.S.T.C. 38 (T.C.C.); and *President’s Choice Bank v. The Queen*, [2009] G.S.T.C. 60 (T.C.C.).

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- managing or administering the assets or liabilities, irrespective of the level of discretionary authority of the particular person who manages some or all of the assets or liabilities;
- providing research, analysis, advice or reports in respect of the assets or liabilities;
- determining which assets or liabilities are to be acquired or disposed of; or
- acting to realize performance targets or other objectives regarding the assets or liabilities.

The draft legislation therefore makes it clear that all types of asset management services, whether discretionary or not, will be subject to GST/HST effective December 15, 2009, and overturns the Federal Court of Appeal's decision in *Canadian Medical Protective Association*. In that case, the Court found that the dominant purpose of certain discretionary investment management services was research and analysis, which were integral to a buy or sell order or a hold decision. As a result, the Court held that the services fell within paragraph 123(1)(l) of the definition of financial service in the ETA as the "arranging for" the transfer of securities, which are financial instruments, and were exempt from GST/HST. As noted above, a legislative reversal of this decision, which has resulted in considerable uncertainty in the investment industry was expected. The CRA's overreaching response was not.

First, on December 29, 2009, the CRA put taxpayer and GST registrants "on notice" with respect to the following GST policy papers:

- GST/HST Policy Statement P-119, *Trailer Commission Servicing Fees*, February 22, 1994 (P-119): "The proposed amendments **may** impact the application of GST/HST to situations and circumstances described in this publication/document." [emphasis added]
- GST/HST Policy Statement P-239, *Meaning of the Term "Arranging for" as Provided in the Definition of "Financial Service,"* January 30, 2002 (P-239): This statement "provides guidance on the meaning of the term "arranging for" in paragraph (l) of the definition of financial service in subsection 123(1) of the ETA. These proposed amendments would impact the application of the GST/HST to situations and circumstances described in this policy statement."

Second, on February 11, 2010, the CRA released GST/HST Notice No. 250, "Proposed Changes to the Definition of Financial Service" (Notice), which is intended to clarify how the CRA will apply the Proposals. The Notice provides several illustrative examples, including the following:

In the course of providing services to investors, an investment dealer arranges to purchase units of a mutual fund for an investor. A commission is paid to the investment dealer at the time the units are purchased. In addition, the investment dealer will receive a fee referred to as a "trailer commission or fee" from the fund manager. The prospectus describes these fees as being paid in recognition of the investment advice and ongoing administrative services rendered by the investment dealer to the investors. The "trailer commission or fee" is paid annually subsequent to the arrangement for the purchase of the units. The services provided by the investment dealer, including advice, arranging for the purchase of the units and on-going administrative services for which the investment dealer is paid the commission and subsequent fees **would not** be a supply of a financial service. [emphasis added]

This example reverses the position taken in P-119, where after considering identical facts, the CRA found that trailer commissions or fees were GST/HST exempt. Therefore, while the Notice states that the Proposals clarify and reaffirm the intent of longstanding policy, the CRA's interpretation of the Proposals, in at least this example, is an undeniable shift from longstanding policy.

In the case of trailer commissions, this policy shift will likely not result in any long-term adverse tax consequences. First, when such commissions are bundled with management fees, fund managers should be entitled to claim offsetting input tax credits. Second, for investment fund dealers who will now be required to charge GST/HST, these taxes paid on their costs in providing such services should be recoverable. In the short term, however, the policy shift does create unexpected implementation costs and concerns. Both fund managers and investment dealers will need to have their systems reprogrammed to accommodate these new taxes. Therefore, even if this policy reversal had been properly announced to industry participants, fairness would have dictated that the implementation date be far enough into the future to prepare for these changes.

What is most surprising and unfair, however, have been the statements of CRA officials regarding their interpretation of the Proposals in other areas, such as front-end load commissions, deferred sales charges and redemption fees paid by investors. These statements, which have not been published in any news release, have been left to disseminate through the tax community and the investment industry, which are already dealing with the repercussions of the upcoming harmonization in British Columbia and Ontario. Similar to the harmonization changes, the increased tax burden will fall squarely on the shoulders of the Canadian investor. Unlike the harmonization changes, the Proposals have a retroactive implementation date. Taxpayers should take some comfort from the fact that there are some carve-outs for “prescribed services” and “prescribed investments” to be enacted by regulation in the future. What remains to be seen is whether such carve-outs will ultimately be necessary to counteract overzealous assessing practices. **T**