BDO Canada

CROSS-BORDER TAX PODCAST SERIES

Episode 17: Section 186 – Input tax credits (ITCs) on the purchase or sale of a business – LIVE in Toronto

Ken Garth:

Hi, this is Ken Garth.

George Tadross:

I'm George Tadross.

Ken Garth:

And you're listening to BDO's Cross-Border Tax Podcast live.

Let's see if I can figure this out. Here we go. IT is not my strong point.

So we're going to discuss Section 186 rules. So last few years have seen a significant uptick in the volume of merger and acquisition activities, whether it's private equity or large buyer groups buying out auto dealerships and veterinary clinics or business owners just looking to retire and liquidate the value of their business. And typically when you're dealing with a purchase and sale transaction, quite often there's a significant amount of fees involved.

On the buyer's side, there may be due diligence expenses, legal and accounting fees likely incurred at both ends, purchaser and vendor.

The vendor may have engaged the services of a broker, so perhaps there's a success fee or some value maximization services, and they're getting a commission when the deal closes, and obviously tax planning.

So vendor may be doing a lot of tax planning prior to the sale to minimize the amount of tax they pay, and the purchaser obviously wants to set up a tax effective structure to buy.

Now, on a larger transaction, these fees can easily amount to several million dollars. And the HST on them obviously could be a few hundred thousand or even into the millions of dollars.

So what we want to look at today is: is there a way that you may be able to recover any of the GST or HST that is paid on these services? I'm going to, just a couple of step back, I guess the terms GST and HST, we just sort of use them interchangeably in the presentation. So essentially the same thing, same legislation. Obviously Ontario, we're paying 13% HST.

And the other thing I just wanted to lay out is that we're going to be looking at this from the perspective of buying and selling shares or debts of a corporation as opposed to a situation where a corporation may be selling off their assets and the vendor's keeping the corporation.

That's kind of outside the scope of this analysis. So we're just looking at sales of shares and debts. So just a very high level overview, and I apologize if this is kind of basic, we already knew that stuff, but I just want to make sure everyone's kind of on a base level. So GST 101, I guess.

Under the GST legislation, shares and debts of a corporation are defined to be financial instruments. And the purchase or sale of a financial instrument is called a financial service. And under most conditions, that's an exempt supply. So an exempt supply means you're not charging or collecting tax. So when you go out onto the stock market and you buy shares of General Motors, you're not paying HST on the value of those shares. Now, when we're looking at claiming input tax credits, the general rule for the GST legislation is you can only get an input tax credit if you're incurring an expense in the course of a commercial activity.

So commercial activity basically means you're making a taxable supply, something that you're charging and collecting tax on.

So on the surface, if I'm incurring an expense to sell shares of a company that's an exempt supply. Typically, I'm going to be booted out of claiming an ITC and there would be no recovery.

Fortunately, there is some relief given under what's called Section 186, and that's what we're going to look at today. 186 does apply in a very specific set of circumstances and to very defined types of expenses, but it is something that could get some recovery of tax paid.

So the way Section 186 works effectively is for purposes of claiming an ITC, if you fall into the rules, it deems your purchaser sale of those shares and debts to be a commercial activity. So it opens up the ability to claim ITCs.

Now, it doesn't deem the sale to be a commercial activity. So it's not like you suddenly have to collect HST on the share sale, it's just for purposes of your ITC eligibility. It says, okay, despite the fact that it's actually an exempt supply, we are going to let you claim an ITC.

So what we first want to do is just go through the conditions that you have to meet to see if you're even in the Section 186.

So first thing is the person claiming the input tax credit has to be registered for GST. That's kind of a basic thing. For anybody who wants to claim an input tax credit, you have to be registered. Now, you should really look at getting registered as early as possible in the process. So when you decide, hey, we're going to be buying or hey, we're going to be selling, consider whether you want to get registered right away. Generally you want to. Typically under the GST legislation a CRA will only backdate a registration, the effective date of a registration by up to 30 days from the date you request it, unless you are actually required to be registered at an earlier date. And a lot of entities that are involved in these purchase sale transactions, if they're just holding companies, may not have any registration requirements. So get your registration in place as early as possible because if you decide two months after a sale concluded that, oh geez, we could have claimed some input tax credits, you may be beyond the point in time when they can backdate you into being able to claim them.

Also, when you're looking at the rules for claiming input tax credits on services, which obviously is a lot of those expenses we laid out are services, you have to be registered on the date that the service was provided, not on the date it was invoiced to you. So again, we're incurring legal fees and tax planning fees. You're going to start incurring those fees very early in the process, so you want to maximize the amount of the expenses that you can claim back. So try and get registered as early as possible.

Now as far as who's eligible to use 186 for a vendor, you can be a corporation, a partnership, or a trust. So originally the rules, when they first came out, it was only corporations and a few years ago they expanded the rules to include partnerships and trusts.

So note though that individuals are not eligible. So if it's an individual selling shares, they can't use 186 to recover. We were actually dealing with CRA on a trust that had sold shares and the person at CRA was adamant that they weren't eligible to claim it, because they had this memoranda that they were reading and it said they weren't eligible. Of course it was because the memoranda they were using was like 15 years old and it was before they'd changed the rules. So it's important we use the current legislation.

And for purchaser side, again, the purchaser could also be a corporation, partnership, or a trust. So again, individuals are not eligible. And then when we're looking at the target, so by the term target, this is the company whose shares or debts we're actually buying or selling, it has to be what's called an operating corporation. So that's kind of a defined term and I want to look into it because sort of a key of being able to claim the ITCs.

So when we're looking at the operating corporation, if our vendor or our purchaser is either a corporation or a trust, the operating corporation has to be related to that person. So obviously if you're talking about the vendor, it has to be related before the sale. And if you're looking at the purchaser, it has to be related after the sale.

Now, the term related, it's the same definition they use under the Income Tax Act. I won't go into it, but typically you have to be controlled or controlled by another person who's related.

Now, if the vendor or purchaser is a partnership, the rules are a little more complicated, but again, the operating corp has to be controlled by either the vendor or purchaser, a corporation that's controlled by the vendor or purchaser. So it allows sort of stacked groups. A corporation that's related to either of those corporations or any combination of them. So it's a little more complicated, but again, it looks back to the concept of are they related?

And then the last test, and this is the one that's obviously of key importance, more than 90% of the property of the operating corporation. And by property, typically we mean assets, have to be used in the course of commercial activities. Remember we spoke earlier about commercial activities. That means something where you're making a taxable supply, you're charging and collecting tax on what you do. So if you look at businesses that might fall into this, an auto dealership, a veterinary practice, maybe an IT or a software developer, pretty much everything they do, they're charging HST, they're probably going to meet this 90% test. It's not guaranteed, but in most cases.

And compare that to let's say a dental practice, which again, a lot of dental practices are being purchased these days, but a dental practice typically makes exempt supplies. The dentist normally doesn't charge HST when they perform services, so they are unlikely to meet that 90% test, and that's a situation where you might not get 186 relief.

So now that we know whether we qualify or not, let's look at the rules or what kind of expenses we could actually claim under Section 186. So there's three subsections, not surprisingly, one, two, and three.

I'm going to look at 186(1), there's a few paragraphs, and then George's going to go through two and three.

So under 186(1), I kind of lumped A and B together because they're sort of similar, but there's supplies that are acquired by the parent. And again, remember the parent could be the purchaser, it could be the vendor, and it could be a corp, a partnership, or a trust, but supplies acquired by the parent for selling or disposing of, purchasing or obtaining or holding units or indebtedness of the operating corporation. So you can see by the fact they allow expenses related to holding units, that actually isn't just restricted to buying and selling. It's during the period of ownership. If you're incurring certain expenses related to your operating corp, you can claim input tax credits on it.

Also, redeeming, issuing, converting or modifying shares or debts of the operating corporation. Again, this is something that may be done in anticipation of a sale, right? Maybe you're redeeming shares, you're exchanging, or it could be stuff that happens during the period of ownership.

And finally issuing or selling units or indebtedness of the parent, not the operating corp, but of the parent where the proceeds are used to acquire shares or debts of the operating corp for use in its commercial activities. So if you look at a situation where the operating corporation, maybe it needs financing to fund its activities and it can't get good commercial terms, the parent entity then could go out and sell shares or borrow money and use that money to lend it or buy additional shares of the operating corp and claim input tax credits. So if you look at a company, let's say, that has to go public to list its shares, those can be some pretty significant expenses. And again, that can be in anticipation of a purchase or a sale or during any period of ownership.

186(1)(C), this applies if more than 90% of the property of the parent corp. And again, property is typically assets are used in any combination of commercial activities. So let's say parent actually carries on its own commercial activities in addition to holding shares and debt and/or shares and debts of operating corporations, and you could have more than one operating corp beneath you.

So if you meet this asset test, then the parent company can claim input tax credits for the purposes of any activity carried on by the parent with a couple of exclusions. Just if you have some activities in respect of shares or debts of someone who's not an operating corp, like if you have a minority interest in an unrelated corp, let's say, or the parent making an exempt supply. So otherwise it sort of opens up the ability for parent to claim ITCs on a very wide variety of expenses.

So George is going to look at sections two and three.

George Tadross:

Thanks, Ken.

So first of all, want to speak to you about subsection 186(2), which we call the takeover test.

So subsection 186(2) allows input tax credits to be claimed for takeover fees where a purchaser is attempting to purchase all or substantially all of the shares of a target corporation. A reason why this subsection is critical is because the GST/HST paid on takeover fees would not be eligible under subsection 186(1), because at the time the costs are incurred, the assets in question are not assets of the parent company.

Subsection 186(2) applies to registered corporations that are resident of Canada, but it does not require that the target corporations will be resident of Canada.

I'll speak more about the Stantec case further on in the presentation, which addresses 186(2) head on. But I thought it would be interesting to discuss some of the other possible scenarios where this subsection may apply.

So what if the target business is also a holding company?

Well, for reasons we'll discuss in further slides, subsection 186(2) should work. That's because subsection 186(3) allows a look through of a chain of companies where the underlying assets of the operating company are in commercial activities.

One thing to note, however, is that if the target corporation is a partner of a partnership, subsection 186(2) will not work. That's because a partnership is defined as a separate person in the Excise Tax Act and is deemed not to carry on the business of the partnership. Because of this, the interest in the partnership would be a financial instrument, and as a result, not used in commercial activities.

Well, what if you were the target of a takeover, can you claim input tax credits? Well, subsection 186(2) only applies to the corporation attempting the takeover, and there have been some GST rulings that have disallowed the ITCs, where a holding company incurred financial advisory costs to determine if a takeover should have been accepted.

Generally costs incurred by the target in relation to a potential takeover would relate to the issuance and purchase of its own shares, and as a result, not in relation to its commercial activities. However, you could look to subsection 185(1), which does provide for some tax credits to be claimed on some limited financial services.

Another question you might have is, what if you abandon any attempt to acquire the takeover, so you give up the pursuit of a company? Well, subsection 186(2) clearly allows any input tax credits throughout the period commencing with the acquisition activities until acquisition or abandoning intention to acquire those shares. Effectively, this means that if the takeover is not successful, it is possible to claim input tax credits on supplies acquired for the purpose of attempting to acquire the shares of another corporation.

The next section is subsection 186(3), which is the look-through rules.

So subsection 186(3) provides for a look-through rule so that a recipient of supply can deal with tiers of a corporation for the purposes of subsections one and two. This subsection of the Excise Tax Act provides that shares owned or indebtedness held by a holding company of a subsidiary corporation are deemed to be acquired for the use by the parent exclusively in its commercial activities, provided that the subsidiary acquired all or substantially all of its shares for the purposes of consumption of commercial activities. And it allows you that it applies to a holding company in a chain of related holding companies.

So a question around this is, is there a limit to the number of tiers for the look through? Now, CRAs responded in a round table on this and said that provided that the conditions of the subsection are met, the section will apply and they give an example.

The example is that if the shares of an OpCo that is engaged exclusively in commercial activities are all owned by a ParentCo, which has no other assets, and that ParentCo shares are owned by GrandparentCo, subsection 186(3) would also apply to ParentCo shares. And they've said there's no factors there beyond the meetings of the condition that would affect the use of this section.

However, once again, if a corporation is a member of a partnership, then it is possible that subsection 186(3) won't apply even if the partnership is engaged in exclusively commercial activities. Again, that's because the partnership would be a separate person from the partner according to the Excise Tax Act, and the partner's interest in that partnership would be a financial instrument and as a result, an exempt supply.

One thing to mention on that note, however, is in 2018, the Department of Finance requested consultation on whether or not the rules that apply to corporations should also be extended to partnerships and trusts.

They've been extended for the ParentCo, but in relation to what you're taking over or the operating companies or the operating entities, GST/HST rules are supposed to be impartial to the structure of an organization. If you think about the nature of the Goods and Services Tax, the meat of the Excise Tax Act is concerned with the taxability of supplies including intangible and tangible personal property, real property, and services. The legislation is mostly structured to not discriminate against the structure of a registrant so long as they're involved in commercial activities.

However, it's very clear in the rules in subsection 186(3) and 186(2) that they clearly favor corporations over other structures. And I should just point out that there have been no proposed amendments in relation to that or based on the consultations.

Now I'm going to pass it on to Ken who will discuss a few housekeeping notes to consider when claiming ITCs under Section 186.

Ken Garth:

Thanks, George.

So if we've determined now that we're an eligible person to claim, we fall into the 186 rules, we've got expenses that we're eligible to claim under one, two, or three, now we actually go to the mechanics of making the claim. And I guess sometimes you have to say the devil is in the details and I think a lot of Section 186 claims that would otherwise be good, sort of fall down on the documentation end of things. And that's just what I want to touch on because it's really so important. What you have to realize is when you're making a claim under Section 186, you may be dealing with an entity that's just recently registered for GST because we've decided, well, we're going to be doing a sale, we'd better get registration in place. They may be filing a return that shows no taxable supplies and no tax collected.

They're claiming a large amount of ITCs and therefore generating a large refund. So it's almost guaranteed this is going to go through what's called a refund integrity review. I'm sure many of you are familiar with that.

It's basically a limited scope audit by CRA on that one return. And so essentially you're going to have to be providing them with an explanation of why you're claiming it, why are you eligible, demonstrate how 186 works and how you fall into it. And they're going to be looking for all the documentation that supports the claim you've made.

So before you make your claim, you really have to make sure you make the effort to make your document, make sure your documentation is all in place.

Again, the first thing, I mentioned this earlier, but I can't reiterate enough: the registration date. We want to get registered as early as possible in the process because of our limited ability to backdate. So if we did happen to get registered, maybe later on in the process, when you're filing your claim, you've got to look at when were these services provided? Do I have any services that have been provided before my registration date? And make sure you've excluded those from your claim.

What else you want us think of is are there any other entities other than our main vendor, our main ParentCo, that we want to get registered? You might have shares of TargetCo that are owned by other entities in your group. There might be partnerships, there might be other corporations or trusts that also hold shares, and those are going to be sold. So do we need to get those entities registered as well?

Sometimes in the course of tax planning, there's new entities being created, whether there's new corporations and shares are being rolled down into these other corporations before they're sold out to the ultimate purchaser. So again, you have to consider, do those other entities have to get registered? Are they the ones who are going to be making a claim under Section 186? So in sort of the flurry of activity leading up to a sale, sometimes these things get overlooked. So every time you've got shares or debts that are owned somewhere, you have to stop and look and say, is this something where we need to get this other entity registered?

And this is just as far as the general input tax credit rules. It's important not to lose sight of them. One of the requirements for you to claim an input tax credit is the person claiming it has to be the recipient of the supply. And the term recipient means they're liable to pay the consideration for the supply you've acquired.

So generally, if we were dealing, let's say with lawyers or accountants or a broker, they're going to file an engagement letter, we're going to have an engagement letter signed with them to provide services. The recipient of the supply should be the person who's going to be claiming that ITC. So if it's a holding corporation, the parent company, it should be the one engaging these various professionals because they're the ones who are going to be selling the shares, they're the ones who are going to be claiming the ITC.

Quite often what we see is it's maybe target company that is the one who enters into these contracts. Well, now the parent isn't really shown as the recipient on the document.

Sometimes there's a workaround for it, but it can get very complicated and sometimes the claims fall through on that. So make sure when you're signing contracts, make sure it's the correct entity that's signing the contract with the suppliers, and you want that to be the entity that's going to be claiming the ITC. And remember, as I said, we might have multiple entities who are going to be claiming under 186. You may want to consider whether they also need to be party to that agreement.

And similar to that, as far as supplier documentation, because that's another thing you're going to have to provide to CRA, one of the requirements is that the supplier invoice has to indicate the name of the recipient of the supply. So again, if the lawyers are invoicing the target company, that's going to cause a problem if you have your holding company trying to claim ITC. So as you're getting these documents in, you should be checking them and making sure that the proper entity is being actually invoiced. And if not, it's easier at that time to push it back and say, you know what? We need this addressed to entity A, B, or C. What you don't want to do is make your claim and now you're going through an audit with CRA, and now you realize that none of your documentation lines up with what you've claimed. Again, that's where you see a lot of these claims fall down. So it's really important to keep that in mind.

And just as far as the date of supply, we mentioned on services that typically you have to be registered on the date the service was provided. One area you may be able to make an argument, let's say we got our registration in place very late in the process just before the deal closed and we're trying to figure out what ITCs can we claim. Well, if we've got anything that's based on a success fee where it's contingent on the deal closing, you get paid or you don't, you might be able to make an argument that even though the services have been provided under this engagement throughout the entire period, we're looking for buyers and they're doing value enhancement services, the actual liability for that tax or the actual event that triggers the tax is the sale of the business.

So maybe it's, you can't really attribute a value to the services that are being performed at an earlier time. So maybe you can walk yourself into claiming an ITC on the deal closing, at least for that kind of service. So it's important to look at what's the nature of the input tax credits you're claiming, and again, are they going to fall within our registration period?

So I think George is just going to go over some court cases that deal specifically with Section 186 just to see how CRA likes to interpret these rules.

George Tadross:

Thanks, Ken.

So I'm going to speak about three distinct but important cases, Stantec, Perfection Dairy Group, and I'm not even going to try to pronounce that last one (Scierie St-Elzear Inc.).

I just want you to keep in mind that all of these cases were related to the old rules and not the ones enacted recently. So if this is tested again in the courts, it could change some things.

So the first case, Stantec is probably the most consequential of the three. In this case, Stantec was a Canadian public company that had several subsidiaries. Its activities were primarily consulting, engineering, architecture, and interior design. These were activities you generally consider to be commercial in nature. Stantec wanted to acquire a company, Keith Industries, a US public company. And in order to do this, it formed a new US subsidiary, Stantec, California, which had then later on merged with Keith Industries.

Now for the takeover to work, Stantec listed itself on the New York Stock Exchange in an attempt to make its shares more desirable to Keith's shareholders. Obviously, as with most public listings, Stantec incurred substantial professional fees, which they later claimed input tax credits on. Now, the CRA denied those fees or the ITCs on those fees on the grounds that Stantec did not acquire Keith's shares directly since it created a subsidiary that merged with Keith.

However, the tax courts ruled that this was far too restricted of an interpretation of subsection 186(2). The courts ruled that because Stantec eventually ended up owning what was Keith, even though it did not directly acquire the shares, it effectively did, and it allowed Stantec to claim those ITCs in relation to the professional fees related to the listing. That was subsequently affirmed by the Court of Appeal, which dismissed an appeal by the CRA and the Crown.

And I just want to point out that the primary subsection reference in that court case was subsection 186(2), the takeover rules and not subsection 186(1), the general HoldCo rules.

In the Perfection Dairy case, the question of what happens in where a operating company ceases to be in commercial activities in relation to Section 186 rules is the meat of that case. So Perfection Dairy was a holding company that was also in the consulting business. So some of its activities were commercial. It had a subsidiary, Perfection Foods Limited, which went into receivership in 1991 and eventually declared bankruptcy. Those bankruptcy proceedings triggered Perfection Dairy and its shareholders to launch a lawsuit for damages of $60 million in 1996 on behalf of the bankrupt company.

The legal fees resulted in almost $24,000 of GST, which Perfection Dairy then claimed an input tax credit on. CRA denied the ITCs on the basis that they did not relate to the commercial activities of Perfection Dairy.

The tax courts allowed the ITCs, but it's rather nuanced, although Perfection Foods was no longer carrying on business because it was bankrupt because it last acquired its assets for the purposes of ending its business, this was considered as part of the commercial activities pursuant to subsection 141.1(3) of the Excise Tax Act. And that allowed subsection 186(1) to apply and allowed Perfection Dairy to claim the input tax credits.

Now, that obviously allowed a very unique situation, which allowed subsection 186(1) to apply where the operating company is bankrupt and/or no longer carrying on any business. So it's very possible that that was the intent of the legislation in order to allow input tax credits to be claimed in holding companies where an operating company ceases to exist. And I do think that might be what the crafters did intend.

The final case, let's just call it SSI, it's a more clear cut case related to subsection 186(1). In this case, SSI was a Forestry Co-Operative, paid $1,000 in GST for tax preparation and financial statement fees for five related companies. Now, they did not have any ownership of any of those companies, they just were simply related. Those companies were all in commercial activities.

Now, CRA denied the input tax credits on the grounds that those services did not advance SSI's activities. The tax court agreed, dismissed the appeal, and the reason was that SSI did not itself own the shares, but were simply related. But it goes back to whether or not something like this would be tested under the new rules.

Now, Section 186 was not deliberately brought up, but that was given because there was no parent subsidiary relationship there.

So what's clear about these older cases that the input tax credits were allowed, where the operating company in question was involved in commercial activities and was either owned by the holding company directly or indirectly, or in the case of Stantec, it was the intent of the parent company to own that company.

So to conclude, Section 186 is often overlooked in restructuring, but it does provide significant opportunities for holding companies to recover the GST/HST paid on substantial fees to the operating companies.

Disclaimer:

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