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Federal Court of Appeal Says Funding Services Not Subject to GST/HST

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In *SLFI Group v Canada* (2019 FCA 217), the Federal Court of Appeal (FCA) overturned a Tax Court of Canada (TCC) decision and ruled that a group of Canadian mutual funds (Funds) was not required to self-assess GST/HST on funding services provided by a U.S. entity, because these services were exempt financial services rather than management or administrative services. In this respect, the FCA stated that rules preventing a manager from reducing the taxable amount of management fees that it charges to a fund by splitting its fees into a financial services fee and a management services fee did not apply where the services were bifurcated between a financing service provided by a third-party financing vehicle and a (reduced-fee) management service that continues to be provided by the manager. However, the FCA concluded that the Funds were not entitled to a full refund of the sales taxes paid in error in the absence of validly filed notices of objection.

Background

The Funds were investment vehicles regulated under Canadian securities law. They had no employees and were provided with management and administrative services by a manager in consideration for management fees, plus GST/HST.

The Funds offered their investors the option of deferring the broker/dealer commissions charged upon purchasing certain securities, referred to as the "deferred sales charge" (DSC) option. At first, the DSCs were funded by the manager but starting on April 1, 2002, an alternative financing method was put in place through an arrangement (Arrangement) with a U.S. subsidiary of Citibank, N.A. (Citibank) that was established for the sole purpose of the Arrangement. The Arrangement provided for Citibank to fund the DSCs in exchange for fees paid by the Funds (Fees).

The Fees were arrived at by adding two components: a percentage of the value of the securities whose commission was financed (Daily Fee) and an amount equal to the redemption fees payable on early redemption of the securities (Redemption Fee). For GST/HST purposes, these two components were given different treatments by the Funds:

1. **The Daily Fee.** The manager self-assessed GST/HST on the Daily Fee on behalf of the Funds, since none of them had a GST/HST registration number prior to July 1, 2010. The manager therefore filed rebate applications for GST paid in error, in its own capacity and/or as "Trustee" or "on behalf" of the Funds. The Minister denied these applications.
2. **The Redemption Fee.** The Funds did not self-assess with respect to the Redemption Fee, which they construed as an exempt supply. The Minister took the position that these supplies were taxable and issued GST/HST assessments to certain of the Funds.

By virtue of the *Excise Tax Act* (ETA), a supply that is a "financial service" is an exempt supply. The supply of "management or administrative service" (or any other service) to an investment plan or any corporation, partnership or trust whose principal activity is the investing of funds is specifically carved out from the definition of "financial service" if it is made by a provider of management or administrative services. In other words, such supply is not exempt and is thus taxable.

At issue was whether the manager of the Funds (which was a provider of management services) delegated its duties to Citibank, with the result that the services were provided on behalf of the manager and were therefore a taxable supply; and, if the Funds manager was not found to have delegated its duties to Citibank, the issue was whether a rebate should have been allowed for GST paid in error.

The TCC's Judgment

The TCC first determined that the services were a single supply and that their "dominant element" was the daily payment of funding into a trust account, a duty initially incumbent upon the manager that was delegated to Citibank. Therefore, the services qualified as "management or administrative services" and constituted an imported taxable supply of management services to the Funds, resulting in self-assessment obligations by the Funds for GST/HST purposes.

The FCA's Decision

The FCA partly allowed the appeal, concluding that the Funds were *not* required to self-assess GST/HST on the Fees, because in fact the services did qualify as "financial services" and were therefore an exempt supply. Nevertheless, the FCA denied the appeal in respect of the GST self-assessed in error by the manager, in view of the absence of any notices of objection filed by the manager.

The Services Were "Financial Services"

On the basis of the evidence adduced at trial, the FCA came to the conclusion that the TCC made a palpable and overriding error that warranted its intervention, by concluding that the services rendered by Citibank were among those that the manager was required to provide to the Funds. According to the FCA, this was evidenced by the fact that the mutual obligations contained in the Arrangement were between Citibank and the Funds – and not with the manager.

Having determined that the services were not made further to a delegation of the management duties of the manager, the FCA further rejected the Crown's argument that Citibank was providing management services. The FCA analyzed the true character of the services on the basis of their "dominant element" and concluded that the services were in the nature of financial services provided by third-party financial institutions and that they did not have the usual characteristics of management services. As a result, the appeal was allowed in part on the basis that the services qualified as financial services and the Funds did not have to self-assess on the Fees.

No Rebate for GST Paid in Error

The ETA provides that a person who paid GST in error can claim a refund unless an assessment has been issued, in which case the person must file a notice of objection rather than a rebate application. Yet, upon the issuance of the impugned GST assessments, the manager and the Funds filed rebate applications rather than objections. The Funds argued that they were allowed to do so since they were never assessed *per se*.

Without pronouncing whether or not the assessments were in fact issued to the Funds – they were issued to the manager after it self-assessed on behalf of the Funds – the FCA ruled that this question was irrelevant because the ETA did not require that the assessment be issued to the person who claimed the rebate. In other words, the fact that the assessments were issued to the manager prevented the Funds from filing rebate applications and the proper and only recourse was an objection by the manager. Consequently, the Funds did not qualify for the rebates and the appeal was denied in that regard. It should be noted that while the manager had filed applications for GST paid in error as of April 2002, only the reporting periods for February 1, 2007 to June 30, 2010 were in dispute.

Takeaway

It is of particular significance that the FCA confirmed that financing arrangements with a person other than the manager of a mutual fund result in supplies of exempt financial services, given the long-standing policy of the Department of Finance that management fees paid by mutual funds be subject to GST/HST, even if management services include what would otherwise be financial services; for instance, a manager could not invoice his services separately to circumvent this rule. Legislative amendments might be seen by the tax authorities as a solution to ensure that this type of arrangement entered into with providers other than a manager is carved out of the definition of financial service.

This case illustrates that investment plans and funds administered by a manager may be able to reduce their sales tax burden by entering into separate agreements with a third party in respect of the portion of the services rendered by the manager that qualifies as financial

services. Special attention should be given to the nature of the services rendered and to the history and characterization of the legal relationships between the parties.

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