THE TAX COURT OF CANADA

ARE FUND INVESTMENT MANAGEMENT SERVICES SUPPLIES OF FINANCIAL SERVICES?

Canadian Medical Protective Association v. The Queen
2008 TCC 33

KEYWORDS: GST ■ FINANCIAL SERVICES ■ EXEMPTIONS ■ MANAGEMENT COMPANIES ■ MANAGEMENT FEES ■ INVESTMENTS

In *Canadian Medical Protective Association v. The Queen*,[16] (*CMPA*) the Tax Court of Canada had its second opportunity this year to consider the goods and services tax (GST) status of investment advisory or management services. In *CMPA*, Bowman CJ

holder" application of paragraph 251(5)(b). The CRA said that it did not, since there was no explicit ruling that that provision must be applied in respect of all options held. See *Tax Topics*, report no. 1867-68, December 20, 2007 (Toronto: CCH Canada, 2007); and "CRA Round Table," in *Report of Proceedings of the Fifty-Ninth Tax Conference*, 2007 Conference Report (Toronto: Canadian Tax Foundation, 2008) 4:1-29.

16 2008 TCC 33.

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found that investment management services were exempt supplies of financial services. He allowed the taxpayer's appeals of the CRA's assessments, which had denied the taxpayer's rebate claims made for GST paid in error on exempt investment management fees.

In *General Motors of Canada Limited v. The Queen*,[17] (*GMCL*) Campbell J of the Tax Court decided that investment management fees were taxable, but allowed GMCL's input tax credit (ITC) claims to recover the GST paid on those fees. In that case, GMCL had appealed the CRA's denial of its ITC claims. In the alternative, if its ITC claims were disallowed, GMCL contended that it should be allowed GST rebates for tax paid in error in respect of exempt supplies of financial services.

The Crown is appealing both decisions to the Federal Court of Appeal.

The Facts in CMPA

The Canadian Medical Protective Association is a not-for-profit corporation that provides medical malpractice insurance to doctors. The doctors fund the insurance program, and CMPA pays out the claims, damages, awards, and settlements made against doctors. The monies paid into the insurance fund are divided between two types of investments—segregated funds (75 to 80 percent of the funds received) and pooled funds (20 to 25 percent of the funds received). CMPA retains the services of investment managers (IMs) to invest its funds on a discretionary basis.

The Parties' Positions in CMPA

CMPA argued that the fees payable to the IMs were paid for exempt supplies of financial services pursuant to section 1, part VII of schedule V of the Excise Tax Act[18] and therefore were not subject to GST. The CRA maintained, first, that the investment management services did not fit within any of the categories of financial services and, second, that the types of services provided by the IMs were specifically excluded from the definition of "financial services." With respect to segregated funds, the CRA argued that the services fell within paragraph (p) of the definition in subsection 123(1) of the ETA, which provides that the service of providing advice is not a financial service. In the case of the pooled funds, the CRA maintained that paragraph (q) of the definition was applicable; paragraph (q) excludes from the definition the provision of a "management or administrative service," or any other service (other than a prescribed service) when supplied by a person who also provides such management or administrative services, to an investment plan[19] or any corporation, partnership, or trust whose principal activity is the investing of funds. The CRA also argued that the paragraph (t) exclusion should apply. Paragraph (t) excludes certain

17 2008 TCC 117.

18 RSC 1985, c. E-15 (herein referred to as "the ETA").

19 Subsection 149(5) of the ETA defines an "investment plan" in regard to the section references.

prescribed administrative services. According to the CRA, the supply made by the IMs "was a single supply for a single consideration" and "was primarily one of providing professional investment advice and funds management."[20]

THE TAX COURT'S DECISION IN CMPA

The critical underlying issue in this appeal was the court's factual determination with respect to the nature of the services provided by the IMs. Like many definitions in taxation statutes, the definition of "financial services" does not provide general guidance on the meaning of the term; rather, it consists of a list of services that are included (paragraphs (a) to (m)) and a list of services that are excluded (paragraphs (n) to (t)). The preliminary issue was whether the services fit within one of the inclusionary paragraphs. The court found that paragraphs (d) and (l) were the most relevant: "Indeed, while other provisions are referred to, the primary focus of the enquiry will be on paragraphs 126(d) and 126(l): 'the transfer of ownership . . . of a financial instrument' or 'the arranging for' [such a transfer]."[21]

The evidence revealed that CMPA's investment committee had established specific guidelines and objectives that the IMs were expected to follow in managing CMPA's investment portfolio, but that the primary responsibility for managing CMPA's funds and investments rested with the IMs. The IMs had complete discretion with respect to the securities to be bought and sold within the guidelines established by the investment committee.

The CRA's position was that the IMs did not arrange for the purchase and sale of securities, but rather merely provided advice on which securities should be bought and sold. In support of its position, the CRA referred to miscellaneous provisions of the investment management agreements, which contemplated the IMs providing advice. For example, CMPA's investment management contract with State Street Global Advisors stated in part that "[t]he Manager shall, based on the information furnished by the Client, and together with the Client, establish an investment policy suitable to the Client, having regard to the Client's needs, objectives and constraints."[22] Another contract confirmed the appointment of the IM "as its investment manager to provide continuing counsel, advice and professional investment services."[23] However, the main witness for CMPA emphatically stated that CMPA did not look to the IMs for advice or counsel. He testified that "[t]he core service is this buying and selling of securities. If they are not doing that, they are not delivering the service you need."[24]

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20 *CMPA*, supra note 16, at paragraph 14, quoting from the CRA's amended reply to the notice of appeal.

21 Supra note 16, at paragraph 14. Note that the quotation is incorrect. The actual section references are to paragraphs 123(1)(d) and (l).

22 Ibid., at paragraph 21.

23 Ibid., at paragraph 25.

24 Ibid.

Bowman CJ summarized the testimony as follows:

> [E]xtreme care is exercised in choosing an IM but once one is retained and a mandate given with respect to a particular asset class—small capitalization equities, high capitalization equities, bonds, indexed funds, pooled funds—the IM is given unfettered discretion to decide what securities to buy and sell and when to do so.[25]

Taking the totality of the evidence into account, Bowman CJ found that "the IMs are retained to buy and sell on behalf of the appellant, in their unfettered discretion, a particular group of securities, whether fixed income or Canadian or U.S. equities."[26] On the basis of this factual determination of the nature of the services provided by the IMs, he concluded that their services constitute "financial services" under a combination of paragraphs (d) and (l) or (c) and (l). Specifically, they constitute "the arranging for . . . the transfer of ownership" or the lending "of a financial instrument."[27]

He then turned his attention to whether the services were excluded from the definition of "financial service" by any of paragraphs (p), (q), and (t). Given the IMs' broad discretion to make investments, he found as a factual matter that, except very occasionally with respect to CMPA's general investment policies, the IMs did not advise CMPA as to what it should do. While relying on their own skill and expertise to perform their services, the IMs decided what investments to make (and, by inference, what investments not to make) and what trades to instruct the brokers to make. The IMs generally did not use their skills and expertise to "advise" their clients. For that reason, paragraph (p), the exclusion from "financial service" for "providing advice," did not apply.

Bowman CJ next considered the exclusion from "financial service" in paragraph (q). He decided that this exclusion also did not apply. The exclusion captures, inter alia, "the provision . . . to any corporation . . . whose principal activity is the investing of funds, of a management or administrative service."[28] Since the Crown conceded—"quite correctly," in Bowman CJ's view—that CMPA's "principal activity is not the investing of funds," it was "sufficient to dispose of the argument under paragraph (q)."[29]

This particular finding is uncontroversial. It applies the Tax Court of Canada precedent in *The Colleges of Applied Arts & Technology Pension Plan v. R*[30] in a straightforward manner. In that decision, the Tax Court found that for the purpose of paragraph (q), the pension plan's principal activity was to calculate and pay pension

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25 Ibid., at paragraph 30.

26 Ibid., at paragraph 43.

27 Ibid., at paragraph 48.

28 Ibid., at paragraph 12.

29 Ibid., at paragraph 54.

30 [2003] GSTC 143 (TCC) (herein referred to as "*CAAT*").

benefits. It was established to promote these aims and carry out these activities. In furtherance of these goals and activities, it invested contributions received by the pension plan (its secondary activities).[31] By analogy, CMPA was established to provide medical malpractice insurance to doctors. In furtherance of this primary objective and "principal activity," which was its raison d'être, it invested the funds received from doctors—that is, the "insurance premiums."

Had Bowman CJ limited his comments on paragraph (q) to the foregoing, the federal government might not have had reason to be particularly concerned about the potentially far-reaching implications of this decision to exempt investment management services generally. However, in his obiter dictum, he stated:

> I turn then to the Crown's contention that the supply is one of "management services". Management services are excluded from the definition of "financial service" by paragraph (q). In the first place, I do not regard the discretionary purchase and sale of securities, whether done expertly or inexpertly, as a management or administrative service ("service de gestion") in ordinary parlance. The juxtaposition in paragraph (q) of the words "management" and "administrative" implies the type of managerial function associated with running a business. Management and administration fees are paid generally to individuals or corporations to handle the variety of matters necessary for the functioning of a business. I should not have thought that "managing" a portfolio of investments carried that type of connotation.[32]

His finding has the potential to exempt investment management services supplied "to any corporation, partnership or trust whose principal activity is the investing of funds" (that is, a fund) or "to an investment plan,"[33] not just special-purpose funds established to provide insurance. In interpreting the word "management," Bowman CJ emphasized its juxtaposition with "administrative." He suggested that the juxtaposition colours the meaning of "management": it "implies the type of managerial function associated with running a business."[34]

In support of the chief justice's view in this case, it is certainly true that back-office administrative support services are significantly different from portfolio investment management services, from which the real value-added benefits come. It is the IMs' investment expertise on which CMPA relies to achieve its return on investment. The relative success or failure of CMPA's investments depends upon the IMs' performance of their management services.

On the other hand, it appears that the investment fund industry itself may give a broader meaning to the term "management" than suggested by the chief justice.

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31 In response to this decision, the federal government amended paragraph (q) to extend its scope to services provided to an "investment plan," which includes registered pension plans. See SC 2000, c. 30, sections 18(3) and (10), with retroactive effect to January 1, 1991.

32 *CMPA*, supra note 16, at paragraph 53.

33 See paragraph 123(1)(q) of the ETA and *CMPA*, supra note 16.

34 *CMPA*, supra note 16, at paragraph 53.

Funds are "managed" by "investment managers." The documents refer to "managed accounts." In one excerpt from an asset management agreement cited by the Tax Court, the following repeated references to "manage" and "management" appear:

> B. The Association wishes to appoint MBL to *manage* a portion of the "fixed income" assets of the Reserve for Claims. . . .
>
> 1. Effective July 1, 2001 (the "Effective Date"), the Association hereby appoints MBL to *manage* the investment of the assets and earnings of the Portfolio as provided in and on the terms and conditions set forth herein and MBL hereby accepts this appointment.
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> 2. As of the Effective Date, the Association shall designate the Portfolio as being *under management* of MBL in accordance with the terms and conditions herein. . . .
>
> 5. MBL shall *manage* and is authorized to invest, re-invest and keep invested the Portfolio, with full discretionary authority, subject to any specific instructions received from the Authorized Representative(s), in accordance with the Statement of Investment Policies, Standards and Procedures of the Reserve for Claims.[35]

The use of the terms "manage" and "management" by the investment fund industry supports the argument that the services provided by the IMs fall within the meaning of a "management service." However, the selection, acquisition, and disposition of investments is the essential element and core of an investment activity and may be considered something more than a "management or administrative service," which has the connotation of a service with an auxiliary character. To the extent that there is any ambiguity that needs to be resolved by a purposive and contextual approach,[36] the term "management services" should take its meaning from the words that surround it. Despite multiple retroactive amendments to paragraph (q), each iteration has consistently sought to exclude a management or administrative service provided to a corporation, partnership, or trust whose principal activity is the investing of funds. The purpose of certain amendments was to tax other services provided with management or administrative services by the administrator or manager to the fund. With these amendments,

> the amendment to paragraph (*q*) of the definition "financial service" is intended to ensure that tax applies to management or administrative services provided to a corporation, trust or partnership whose principal activity is the investing of funds. This provision is also intended to ensure that the application of tax to such services is not circumvented by an "unbundling" of services provided to the entity. Therefore, the amended paragraph makes explicit reference to "any service" provided by a person who provides management or administrative services.[37]

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35 Ibid., at paragraph 23 (emphasis added).

36 See *The Queen v. Canada Trustco Mortgage Company*, [2005] 2 SCR 601; 2005 SCC 54.

37 See Department of Finance, Notice of Ways and Means Motion, To Amend the Excise Tax Act, December 7, 1994, Amendments to the Excise Tax Act, the Income Tax Act, and Related Acts: Notice of Ways and Means Motion, Draft Regulations and Explanatory Notes, April 23, 1996,

It is quite common in the fund industry for an IM to provide administrative services with its investment management services. The real value added flows from the investment management services. The IM is hired is for its investment management abilities, and the IM receives its compensation substantially for its investment management services. From a policy perspective, it makes little sense for the government to tax all the services provided to a fund if the IM happens to provide miscellaneous administrative services to the fund, but not to tax the investment management services if the IM provides no administrative services to the fund.

Finally, Bowman CJ dealt with the exclusion in paragraph (t) for administrative services prescribed under the Financial Services (GST/HST) Regulations.[38] For this purpose, regulation 4(2)(b) prescribes "any administrative service." The chief justice was not prepared to broaden the meaning of "administrative" in the regulations beyond its meaning in paragraph (q) of the enabling legislation. He adopted the reasoning of Bowie J in *Royal Bank of Canada v. The Queen*: administrative services cover ancillary support services such as data processing and record keeping, but not the activities specifically enumerated in paragraphs (a) to (m) of the "financial service" definition, of which the arranging for the buying and selling of securities is one.[39] The second part of this reasoning is less than satisfactory. The purpose of paragraphs (n) to (t) of the definition is to exclude services otherwise included within "financial service" in paragraphs (a) to (m). The inclusions and exclusions need to be read harmoniously with each other. The exclusions clarify what types of services are not intended to be captured within the above inclusions. While certain services may have certain aspects or traits of a "financial service," they are not financial services if the dominant element of the supply is enumerated in any of paragraphs (n) to (t).

THE GMCL DECISION

GMCL acted as a pension administrator for its employee pension plans. It invested in master trusts, and the investments were split between foreign pension investments and domestic pension investments. GMCL decided how to allocate the funds among broad categories of investments, such as domestic equity, foreign equity, domestic fixed income, domestic short-term fixed income, and domestic cash equivalents. GMCL then engaged different IMs to manage the investment of funds and securities within one or more of these asset categories. Subject to GMCL's investment guidelines in schedule A of the IM agreements, GMCL authorized "their power as full discretionary Investment Managers. They were also subject to the Trustee's ongoing

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which makes certain refinements to these amendments by excluding certain prescribed services from the application of paragraph (q) and thereby excluding those prescribed services from taxation.

38 SOR/91-26, as amended by SOR/2001-61, retroactive to the introduction of the GST on December 31, 1990.

39 2005 TCC 802, at paragraph 18; aff'd. 2007 FCA 72.

monitoring and authority to approve or deny the buy/sell orders because the Investment Managers had no access to the funds."[40]

In this case, there were two related issues:[41]

1. Whether GMCL was entitled to ITCs for the GST paid to the IMs on their fees for services.
2. Alternatively, whether the IMs' services were exempt financial services, entitling GMCL to GST rebates for tax paid in error on the IMs' fees.

The Tax Court found that the IMs made taxable supplies of their investment management services to GMCL, for which GMCL could claim ITCs to recover 100 percent of the GST paid. Testimony supported the argument that the employee pension plans were part of the employee compensation packages intended "to attract and retain the highest quality employees."[42] Accordingly, the Tax Court found that GMCL had acquired the IMs' services to attract and retain employees for its "commercial activity" of manufacturing and selling motor vehicles, thus enabling it to claim the ITCs pursuant to section 169 of the ETA.

For the purposes of this case comment, we are principally concerned with the court's analysis and resolution of the second issue. In arguing for exemption of the IMs' services as financial services, GMCL placed great reliance on the decision in *CAAT*.[43] The Tax Court judge disagreed. In that case, the IM's services were not excluded from "financial service" under paragraph (q), as then written, because the "principal activity" of the CAAT pension plan was not investing funds, but calculating pension contributions and benefits, receiving contributions, and paying benefits. The *CAAT* decision did not deal with whether discretionary investment management services fit within the definition of "financial service" in paragraphs (a) to (m), as GMCL contended. Since the parties in *CAAT* had withdrawn their arguments over those paragraphs after discovery, no arguments were put before the court in *CAAT* on their application.[44]

Campbell J found that the investment management services did not come within paragraphs (a) to (m) of the definition of "financial service." She found that GMCL

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40 *GMCL*, supra note 17, at paragraph 13.

41 Ibid., at paragraph 27.

42 Ibid., at paragraph 8.

43 Supra note 30.

44 It is interesting that in *CAAT*, supra note 30, the CRA did not challenge the underlying issue of whether an IM's services qualify as a "financial service" under paragraphs (a) to (m). Since the CRA had agreed before trial to concede this critical issue, perhaps it believed that it was not an appropriate test case for this issue. With this case decided on the narrow point of paragraph (q) and the government having amended paragraph (q) retroactively to January 1, 1991 to limit the application of this adverse decision on paragraph (q), the CRA may have made a strategic choice not to argue about whether an IM's services meet the threshold eligibility to qualify as a "financial service" to limit the precedential value of the case.

paid the IMs not for executing securities trades, "but for portfolio management that would maximize returns."[45] Since the trustee controlled the access to the monies in the trusts' bank accounts and either or both of the trustee and GMCL could veto the execution of buy-sell orders placed by the IMs, Campbell J found that the IMs "did not possess the authority nor the means to 'arrange for' the transfer of financial instruments for GMCL" within the meaning of paragraphs (d) and (l) of the definition of "financial service."[46] Had it been necessary to do so if she had found that the IMs' services had fallen within any of paragraphs (a) to (m) of the definition of "financial service," she would have excluded the services from the definition of "financial service" as advisory services captured in paragraph (p).[47]

CMPA Versus GMCL: Can the Two Decisions Be Reconciled?

After evidence and arguments in *CMPA* were completed, Campbell J released her decision in *GMCL*. Bowman CJ gave both parties an opportunity to make submissions in respect of the *GMCL* decision. Since the federal government had appealed the *GMCL* decision to the Federal Court of Appeal, the chief justice did "not propose to comment on it more than is necessary."[48] In distinguishing between the two cases, he said:

> In the case of CMPA it is clear beyond any doubt on the evidence that the IMs were not providing advice. It is equally clear that GMCL exercised a great deal of control over the decisions of the [IMs] and relied upon the advice given to it by them.[49]

Although he distinguished the two cases by the degree of control exercised over the IMs, as a practical matter there may have been little difference in the manner and nature of the services that were performed in the two cases. The facts in *GMCL* established that GMCL retained the authority to veto any investment decisions made by the IMs, but there is little indication that this authority was exercised. In both the *CMPA* and *GMCL* cases, the brokers were told what trades to execute. The IMs and parties to the security transactions relied on the brokers to execute security trades. Brokers acted as intermediaries in "arranging for" the transfers of financial instruments between parties.

By breaking the link between the IMs' selection of the securities to be purchased and sold and the actual purchase and sale of the securities, Campbell J found it easier to conclude that the IMs were basically providing advice, akin to providing lists

45 *GMCL*, supra note 17, at paragraph 95.

46 Ibid., at paragraph 99.

47 Ibid., at paragraph 102.

48 *CMPA*, supra note 16, at paragraph 59.

49 Ibid., at paragraph 60.

of securities which the IMs were recommending that GMCL buy or sell. Campbell J believed that the IMs were paid to manage investment portfolios to maximize returns, and that their judgment (and explicit or implicit advice) as to those securities that should not be purchased was as critical to investment performance as their judgment and advice as to those securities that should be purchased. Bowman CJ, on the other hand, found that the IMs were buying and selling (or lending) securities (albeit through brokers) and thus were arranging for the transfer (or lending) of financial instruments. No doubt there were significant differences between the two cases in the evidence that was led; however, the different result also reflects the different viewpoint of the two justices in the characterization of portfolio management services.

Broader Implications

These two decisions have potentially far-reaching implications. Funds are generally engaged in making exempt supplies of financial services and therefore are restricted from claiming ITCs to recover GST paid on their inputs. Relying on the precedent in *CMPA*, IMs could credit or refund to funds GST charged or collected in error within two years and claim adjustments on their own GST returns.[50] This approach exposes the IMs to the risk of disallowance of their GST adjustments if the CRA disagrees with the view that they made exempt supplies of financial services. The better option may be for the funds to directly claim protective GST rebate claims within the two-year statutory claim period,[51] pending the resolution of these two cases. If a rebate claimant was ultimately successful, the outcome would probably have negative implications for the claimant's IM. Since the IM would make exempt supplies of financial services to the claimant, the IM would be subject to disallowance of ITC claims relating to these activities.

On mixed findings of fact and law, as in *CMPA* and *GMCL*, the standard of review for reversal at the Federal Court of Appeal is high, requiring a palpable and overriding error.[52] Even if the Federal Court of Appeal ultimately supports Bowman CJ's view in *CMPA*, the federal government will likely not accept a general exemption for fund investment management services. The government has already made multiple retroactive amendments to paragraph (q) of the "financial service" definition. It could once again seek to amend paragraph (q) retroactively (or seek to amend another part of the definition retroactively) to make it patently clear that "investment management services" are excluded from the definition of "financial service." It took this approach in 2006 in excluding "a debt collection service" from "financial

50 Pursuant to section 232 of the ETA.

51 Pursuant to section 261 of the ETA.

52 See *Royal Bank*, supra note 39, at paragraph 3 (FCA).

service" in paragraph (r.2).[53] This prospect may discourage parties from seeking to invest in GST savings planning opportunities presented by the *GMCL* and *CMPA* decisions. As it has done with other GST amendments, the government could limit the exception to the retroactivity of any amendments to the litigants in these two cases, thereby extinguishing any rights to GST relief claimed by adjustments or rebates before the announcement of the amendments.

These cases illustrate how difficult it may be in certain instances to distinguish between exempt financial services and taxable services. When a discount broker charges commissions for its securities trades executed, it is clear that it is supplying financial services of arranging for the transfers of securities. When a full service broker provides advice on specific investments and limits his or her remuneration to commissions for the securities trades actually placed, the *GMCL* decision calls into question whether the broker is making exempt supplies of arranging for the transfers of securities, or whether it is providing taxable advisory or investment management services.

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