CAN THE BRAIN RENDER A SERVICE TO THE HAND?

State Farm et al. v. The Queen
2003 GTC 632; [2003] GSTC 35

KEYWORDS: ANTI-AVOIDANCE RULES ■ DEDUCTIONS ■ FINANCIAL SERVICES ■ GST ■ PERMANENT ESTABLISHMENTS ■ STATUTORY INTERPRETATION

In this goods and services tax (GST) case, Judge Bowman of the Tax Court raises a number of far-reaching issues relating to the drafting and interpretation of deeming provisions. His judgment is also interesting (and entertaining) for its philosophical and metaphysical musings.

This case is the first to consider section 220 of the Excise Tax Act.[29] Section 220 applies where a person carries on business through a foreign permanent establishment (PE) and a Canadian PE, and the foreign PE transfers property or renders a service to the Canadian PE. The section operates through the application of four interdependent deeming provisions. More specifically, section 220 of the GST legislation deems a property transferred, or a service rendered, by the foreign PE to the Canadian PE to be a supply of property or a service between two separate persons who deal with each other at arm's length for fair market value (FMV) consideration. This consideration is deemed to be due to the foreign PE and paid by the Canadian PE at the end of the person's taxation year under the Income Tax Act. Section 220 of the GST legislation is designed to ensure that a person who imports intangible personal property or a service pays GST in the same manner as it would have had it acquired the property or the service from an arm's-length supplier.[30] The purposes of section 220 are (1) to put a person who acquires the property or service from an arm's-length person on an equal competitive footing with the person who imports the property or service on its own behalf, and (2) to prevent GST leakage or avoidance.[31]

In *State Farm*, Judge Bowman correctly found that the CCRA's basis for assessment under section 220 of the GST legislation was fundamentally flawed. The CCRA's approach on audit extended beyond the intended scope of section 220. Judge Bowman also raised a number of issues about section 220 and other deeming

29 RSC 1985, c. E-15, as amended, parts VIII and IX (herein referred to as "the GST legislation").

30 See Canada, Department of Finance, *Goods and Services Tax: Explanatory Notes to Bill C-62 as Passed by the House of Commons on April 10, 1990* (Ottawa: Department of Finance, May 1990); and Canada, Department of Finance, *Explanatory Notes to Legislation Relating to the Goods and Services Tax* (Bill C-112) (Ottawa: Department of Finance, February 1993). Division IV of the GST legislation, including section 220, does not apply to goods imported into Canada. It is division III of the GST legislation that imposes GST at the border on an imported good (in the same manner as a customs duty).

31 See the explanatory notes to Bill C-62, supra note 30, and the explanatory notes to Bill C-112, supra note 30.

provisions in tax legislation. In his obiter comments, he questioned whether section 220 could *ever* deem an entity's foreign PE to make a taxable supply of services to its Canadian PE. He sent a clear message to legislative drafters, to be certain that legislative provisions achieve their intended purposes; otherwise, the courts may be unable to give them effect. He also sent a clear message to the courts, taxing authorities, and tax practitioners in interpreting deeming provisions in tax legislation: one must not jump to conclusions about the legal effect of such provisions. The words must be read carefully in the context of their intended objectives to see whether, in fact, they achieve those objectives.

The facts in *State Farm* may be summarized as follows. State Farm Mutual Auto Insurance and State Farm Fire & Casualty Company (together, "State Farm") are US corporations licensed to carry on the insurance business in all 50 US states and in Alberta, Ontario, and New Brunswick. They are the largest automobile, fire, and casualty insurers in North America. In Canada, State Farm insurance is sold through independent sales agents. State Farm's head office (HO) is located in Bloomington, Illinois, and its Canadian regional office (CRO) is located in Scarborough, Ontario. Pursuant to subsection 123(1) of the GST legislation, both HO and CRO are PEs for GST purposes.

The central issue in the case was whether expenses allocated by HO to CRO were subject to GST. HO allocated expenses to CRO for insurance regulatory purposes and for determination of the profit of the Canadian PE for Canadian income tax and accounting purposes. According to the CCRA, CRO had acquired "imported taxable supplies" of administrative or management services from HO for FMV consideration equal to the accounting allocation. In the CCRA's view, sections 217, 218, and 220 in division IV of the GST legislation had the combined effect of imposing GST on the FMV consideration (accounting allocation) payable by CRO for the imported taxable supplies acquired from HO.[32]

In analyzing the basis for the CCRA's assessment, Judge Bowman found that the CCRA had failed to address two of the conditions for section 220 to apply. It did not provide evidence as to (1) the nature of the services rendered by HO to CRO or (2) the FMV of those services. Judge Bowman certainly needed to see evidence related to the first condition, as we will see later in his obiter comments. On the second

32 Division IV of the GST legislation levies GST on imported taxable supplies of intangible personal property and services. The definition of "imported taxable supply" is found in section 217 of the GST legislation. The definition of "imported taxable supply" and division IV GST do not apply where the importer acquires the property or services for its exclusive consumption, use, or supply in its "commercial activities." Division IV GST is not imposed in these circumstances because the importer, if registered for the GST, would be eligible to offset the GST liability with an input tax credit on the same GST return. Pursuant to subsection 123(1) of the GST legislation, a "commercial activity" excludes the making of exempt supplies. The underwriting and issuing of insurance policies are exempt supplies of financial services.

condition, the CCRA had failed to plead the assumption that the accounting allocation was "equal to the fair market value of the service."[33] Judge Bowman noted that "what the fair market value, if any, is of such a service is something that must be determined independently of any deeming provision."[34] Judge Bowman found that the Crown's failure to plead any assumptions or facts in this respect might well, in itself, have been sufficient to justify allowing the appeals.[35]

Judge Bowman then took his analysis one step further. He postulated that if HO had rendered services to CRO for FMV consideration equal to the accounting allocation, those services could not possibly be "imported taxable supplies" of administrative or management services. In his view, any such services would be exempt supplies of financial services. He stated, "Even if it could be said that head office provided a service to the CRO that service consisted substantially, if not entirely, in the area of underwriting insurance policies."[36] The underwriting of insurance policies is an exempt supply of financial services.[37]

As further support for the GST exemption, Judge Bowman found that to the extent that HO did perform any administrative or management services for CRO, they were "incidental to the financial services supplied."[38] Under section 138 of the GST legislation, these incidental supplies of administrative or management services would merge into the predominant exempt supplies of financial services and, accordingly, would lose their identity as separate taxable supplies.

In the alternative, if any administrative or management services provided by HO to CRO were not incidental supplies as contemplated under section 138, Judge Bowman found that the exemption in section 139 would apply. All of the conditions of section 139 would be satisfied, as follows:[39]

- HO supplied one or more financial services (insurance underwriting services) with one or more non-financial services (administrative or management services), for a single amount.
- The financial services were related to the non-financial services.
- It was the usual practice of HO to supply the insurance underwriting services together with the other services in the ordinary course of business.

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33 *State Farm et al. v. The Queen*, 2003 GTC 632; [2003] GSTC 35, at paragraph 31 (TCC).

34 Ibid. CCRA's *Information Circular* 87-2R, "International Transfer Pricing," September 27, 1999, paragraphs 154 to 171, may be a suitable source for determining how to calculate the FMV for any services rendered between PEs.

35 Supra note 33, at paragraphs 31 and 78.

36 Ibid., at paragraph 79.

37 Paragraph (h) of the definition of "financial service" in subsection 123(1) of the GST legislation.

38 Supra note 33, at paragraphs 12 and 80.

39 Ibid., at paragraphs 11 and 81.

- If the insurance underwriting services and administrative or management services had been billed separately, the consideration for the insurance underwriting services would have constituted more than 50 percent of the total of all amounts received by HO for all services.

Judge Bowman then went beyond these reasons to discuss the operation (or inoperability) of section 220 generally. His obiter comments are the most conceptually challenging part of the judgment. The source of the difficulties with section 220 is its use of four deeming provisions to create statutory legal fictions. Their intended effect is to alter reality so as to achieve Parliament's overriding tax policy objectives. As we previously stated, these policy objectives are (1) to put a person who acquires the property or service from an arm's-length person on an equal competitive footing with the person who imports the property or service on its own behalf, and (2) to prevent GST leakage or avoidance.

The trick is in correctly applying the deeming provisions. We must know how far the statutory fiction goes and when to leave it behind and revert to reality. As noted by Sullivan and Driedger,

> [a]lthough a sovereign legislature cannot change reality it can declare it to be different from what it actually is or was.
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> When "deems" is used to create a legal fiction, the fiction cannot be rebutted. The facts as declared by the legislature govern even in the face of irrefutable evidence to the contrary. The difficulty that arises in interpreting legal fictions is determining the scope of the fiction.[40]

Section 220 of the GST legislation operates only where a person's foreign PE transfers property or renders a service to its Canadian PE. In his obiter comments, Judge Bowman doubted whether section 220 could expand the GST net to capture intracompany "services" rendered by a person's foreign PE to its Canadian PE. How can it be said that one PE is providing services to the other in *State Farm*? As the judgment explains, the insurance business is divided into four essential functions: selling insurance policies, underwriting, claims, and investment. The two PEs split these functions between them to accomplish State Farm's insurance business objectives. Given how closely integrated their roles are, can it really be said that one PE is rendering services to the other? In fact, the two PEs are acting in concert as one legal entity to carry out the activities of the insurance business carried on by State Farm.

Section 220 of the GST legislation appears to be at least one deeming provision short of what is required to give effect to its intended purposes. It needs a provision to deem the foreign PE to render services to the Canadian PE. In explaining this problem, Judge Bowman considered the metaphysical and philosophical dimensions:

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40 Ruth Sullivan, *Sullivan and Driedger on the Construction of Statutes*, 4th ed. (Markham, ON: Butterworths, 2002), 69.

> The problem with section 220 is that it creates a statutory fiction, or, if you will, an artificial presumption, but it does not direct us to pursue that presumption to its logical (or illogical) conclusion. It leads us to the end of the diving board but provides us with no pool in which to jump. It is possible that the inarticulate premise of section 220 is that foreign permanent establishments render services to Canadian permanent establishments but this is not stated. If that is the premise it does not matter that one may be the foreign head office and one the Canadian branch or vice versa. Yet the premise has no rational basis. One could as readily say that a branch office in Canada renders services to a foreign head office. If one enjoys philosophical conundrums, one might ask if the brain renders a service to the hand or the hand renders a service to the brain. The simple fact is that parts of a single organism, whether physical or financial, whether concrete or abstract, do not render services to each other and deeming the parts to be separate persons, as section 220 does, does not overcome this fundamental conceptual obstacle, even though branch accounting practices and subsection 4(1) of the *Income Tax Act* require a reasonable allocation of expenses to sources in a particular place.[41]

In his obiter comments, Judge Bowman hinted at yet another hurdle in the application of section 220 of the GST legislation. Although he found considerable merit in the appellant's argument that "if any services are performed they are performed by employees of the appellants and are therefore not services as deemed in subsection 123(1),"[42] he found it unnecessary to rule on this argument because his conclusions, noted above, were sufficient to allow State Farm's appeal.

This argument warrants further discussion. It focused on two potentially conflicting deeming provisions in the GST legislation. Specifically, section 220 may conflict with the definition of "service" in subsection 123(1). The definition of "service" carves out "anything that is supplied to an employer by a person who is or agrees to become an employee of the employer in the course of or in relation to the office or employment of that person." That is, an employee's activities performed on behalf of his employer do not constitute supplies of services made to the employer, but constitute non-transactions, for GST purposes. This definition arguably conflicts with section 220 because section 220 would deem employees working at an entity's foreign PE to make supplies of services to the entity's Canadian PE (the employer). It could be argued that by deeming the foreign PE and Canadian PE to be separate persons, section 220 implicitly deems the employees of each PE to be employed by a separate person. Otherwise, section 220 would become inoperable. In choosing between two competing interpretations, we must assume that Parliament intended the one that would make section 220 operable. Moreover, another principle of statutory interpretation holds that the more specific legislative provision in section 220 should prevail over the general legislative provision setting out the definition of "service" in subsection 123(1). Given the fundamental problem

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41 Supra note 33, at paragraph 77.

42 Ibid., at paragraph 89.

with section 220 in accomplishing Parliament's overriding policy objectives, this statutory interpretation may prove to be of little benefit to the CCRA.

Parliament could look to article VII of the Canada-US income tax convention, 1980[43] for appropriate wording in redrafting section 220 of the GST legislation to achieve Parliament's intended tax policy objectives. In *Cudd Pressure Control Inc. v. The Queen*,[44] Cudd Pressure Control Inc. ("Cudd Pressure"), a US-based company with a PE in Canada, entered into a contract with Mobil Oil Canada Limited ("Mobil Canada") to provide snubbing unit services in Canada on an offshore oil drilling rig owned by Mobil Canada. The CCRA and the courts rejected Cudd Pressure's Canadian income tax deduction for rent notionally payable by its Canadian PE to its foreign PE for the use of the equipment in carrying out its contract with Mobil Canada. Cudd Pressure was restricted to claiming capital cost allowance for its use of the equipment in Canada. Obiter comments made in one judgment in the Federal Court of Appeal, however, left open the possibility of a deduction for rent notionally payable from an entity's Canadian PE to the entity's foreign PE in appropriate circumstances.[45] That judgment cited article III of the Canada-US reciprocal tax convention, 1942[46] (the predecessor to article VII of the Canada-US treaty), which requires that the net commercial profits of each PE be determined as if each PE "were an independent enterprise engaged in the same or similar activities under the same or similar conditions."[47] Section 220 could be reworded to deem an entity's Canadian PE to acquire services from its foreign PE if the Canadian PE could acquire the same services from "an independent enterprise engaged in the same or similar activities under the same or similar conditions."

Such a provision still might not apply in the *State Farm* circumstances. The activities of the foreign PE and the Canadian PE may be so inextricably intertwined that it is impossible to separate them into two independent enterprises. It may be impossible to conclude that either PE could operate as an independent enterprise.

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43 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997 (herein referred to as "the Canada-US treaty").

44 95 DTC 559; [1995] 2 CTC 2382 (TCC); aff'd. 98 DTC 6630; [1999] 1 CTC 1 (FCA).

45 Ibid., Federal Court of Appeal judgment of Justice McDonald, at paragraphs 5 to 38, particularly paragraphs 29, 30 to 33, and 37. In particular, for the Canadian PE's deduction to be available, the foreign PE would have had to recognize the notional rent in its income on its foreign income tax return and a reasonable independent third party in circumstances similar to those of the Canadian PE would have had to agree to rent the equipment from the foreign PE.

46 Convention and Protocol Between Canada and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the Case of Income Taxes, signed at Washington, DC on March 4, 1942, as amended by the protocols signed on June 12, 1950, August 8, 1956, and October 25, 1966 (herein referred to as "the 1942 Canada-US convention").

47 Article III(1) of the 1942 Canada-US convention.

There is no question that Judge Bowman reached the correct decision in *State Farm*. Moreover, in his obiter comments, Judge Bowman explored issues with far-reaching consequences with regard to the statutory fictions established by the deeming provisions in section 220 of the GST legislation and in tax legislation generally. He questioned whether the conditions for the application of section 220 could *ever* be satisfied, at least in the case of services. He suggested that Parliament's overriding tax policy objectives may not have been adequately reflected in the drafting of section 220, and that the section may have to be redrafted in order to achieve those objectives. Without legislative amendments to section 220, it remains to be seen whether a court in a subsequent case will adopt Judge Bowman's obiter comments into law in the appropriate case.[48] For legislators, taxing authorities, taxpayers, lawyers, and judges, Judge Bowman's enlightened obiter comments should serve as a beacon in guiding the statutory drafting and interpretation of legislative deeming provisions.[49] In the final analysis, the onus is on taxpayers, their legal advisers, and the courts to determine whether the conditions for the application of deeming provisions are satisfied and the extent to which those statutory fictions apply.

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48 We understand that the Crown has not appealed Judge Bowman's decision in *State Farm*. It will be interesting to see to what extent, if any, the CCRA amends its GST/HST *Policy Statement* P-126: "Intra-Company Cost Allocations by Foreign-Based Insurance Companies," March 24, 1994, in light of this decision.

49 Section 191 of the GST legislation provides examples of workable rules to deem a "builder" of a "residential complex" to make a taxable "self-supply" (taxable supply to himself) and to impose GST against the builder on the FMV of the complex. The builder is required to self-assess and remit GST on the FMV consideration deemed payable by the builder for the taxable supply of the residential complex from himself to himself.