INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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Mr. Bob Hamilton
Assistant Deputy Minister
Tax Policy Branch
Department of Finance
140 O'Connor Street
Ottawa, ON K1A 0G5

Re: IIAC comments on draft goods and services tax legislation and other matters

The Investment Industry Association of Canada (IIAC) requests changes in the following key areas of the draft goods and services tax (GST) legislation tabled January 26, 2007 relating to the financial services sector, as well as to the proposed Annual Schedule. The IIAC represents nearly 200 independent and bank-owned securities dealers, large and small – institutional, retail and integrated – from across the country on matters affecting members and Canadian capital markets generally. As the proposed changes may have potentially significantly impacts on our membership, we would like to express our concerns and recommendations, specifically with respect to the proposed:

- Prescribed input tax credit (ITC) recovery rate
- Retroactivity of the application of the legislative changes to November 2005
- Changes to the GST treatment of imported supplies
- Changes to the Annual Schedule
- Administrative changes.

Our members believe that any changes must provide for the maximum certainty on a timely basis, be fair, and be reasonably simple to understand and implement cost-effectively. As we think that key proposed changes, unfortunately, contradict these goals, we request that, *before* proceeding with implementation of the draft changes, Finance:

1. Provide us with details as to why the proposed legislative changes are required as regards the securities sector of the financial industry – our members, already subject to extensive audits that allow for the identification of any concerns, are not aware of any consistent issues within the securities dealer community

2. Estimate the financial effect – direct and indirect – of the changes on the sectors (or at least the securities sector) and how the 15 per cent rate applicable to securities dealers was calculated; as it is, our members bear an estimated $135 million in unrecoverable GST, financial services being one of the few sectors that experienced a net increase in the cost of consumption taxes when federal sales tax was eliminated and the GST was brought in

3. Explain how the proposed changes – specifically, the prescribed ITC recovery rate and the taxation of non-taxable-in-Canada input sources in the case of imported non-arm's-length transactions (NALTs) – are consistent with principles of value-added taxation (VAT)

4. Share comparable tax provisions from legislation in other Organization for Economic Co-operation and Development (OECD) countries to demonstrate how the proposed changes promote a level playing field internationally and domestically where certain advisory services may be offered by non-financial institutions – globalization of the financial services sector, increasing competition internationally and domestically, and growing diversification of the businesses our members are in due to ongoing deregulation are trends that are already increasing challenges that Canadian firms are facing in Canada and on a cross-border basis.

The March 19, 2007 federal budget focused on:

- Lowering taxes for business to spur innovation and growth
- Reducing unnecessary regulation, red tape and the tax compliance burden
- Securing a competitive advantage in global capital markets – the Finance Minister stated the government's intention to pursue free trade in securities, from which can be inferred an increase in the ITC allocation rate of firms that are able to export more to a recovery rate of greater than 15 per cent
- Equipping Canadian businesses for global success.

We may have misinterpreted aspects of the proposed amendments, however, without answers to points 1. to 4. above, the draft legislation appears to us to be leading away from equipping Canadian businesses for global success and towards a growth in net unrecoverable GST, an increase in compliance costs and an expansion in cost impediments to global competition for Canadian dealers. This, on top of other capital-markets-/financial-firm-related announcements in the budget (interest deductibility, withholding tax elimination), may well have their impacts felt before the benefits of free-er trade may provide benefits.

To clear up possible misunderstandings on our part, we would very much appreciate the opportunity of meeting with your staff and, if this is reasonable, other market segments to discuss the issues of principle outlined above, as well as our attached more detailed comments. We will call in the near future to find a date convenient to your staff to meet.

Yours truly,

cc: Mr. Lalith Kottachchi

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IIAC COMMENTS ON DRAFT GST/HST LEGISLATION AND FORMS (April 30, 2007)

Below are securities dealer comments on the draft legislation. The comments are at a high level as we believe that we do not yet have a sufficiently clear understanding of the rationale for some of the proposed changes. The 2005 and 2007 backgrounders are not clear on

- Why the proposed legislative changes are required as regards the *securities* sector
- The financial effect – direct and indirect – of the changes on the sectors (or at least the securities sector) and how the 15 per cent rate applicable to securities dealers was calculated
- How a maximum ITC recovery rate and taxing non-taxable-in-Canada imported non-arm's-length inputs are consistent with principles of value-added taxation (VAT)
- Whether tax provisions from legislation in other Organization for Economic Co-operation and Development (OECD) countries are comparable to what is proposed.

Input tax credit (ITC) allocation method

The backgrounder to the draft legislation says that a new legislative framework for the GST/ harmonized sales tax (HST) input tax credit allocation regime applicable to financial institutions is being introduced to streamline the application of the GST/HST input tax credit rules for these institutions and reduce the uncertainty arising from the lack of specific guidance in the current legislation. As we see it, the draft legislation makes the allocation process more complex for most parties, appears less fair for some firms and, during the period during which a rate is being negotiated or renegotiated, may be problematic from the basis of pricing certain services.

In the late 1980s and early 1990s, there was extensive consultation and discussion between members of the financial services sector, Department of Finance and what is now the Canada Revenue Agency (CRA). While there were disagreements prior to enactment of the GST legislation, since that time there has been no evidence or no formal communication that we are aware of regarding concerns from Finance or the CRA regarding ITCs claimed or the ITC allocation methodology of securities firms. Financial institutions, including our members, invested time and money in developing methodology, systems and processes to capture what is reasonable to satisfy auditors.

That said, we believe that the proposed changes will lead to an increase in unrecoverable GST and an increase in compliance costs for the industry. If there is a conscious intention to increase the unrecoverable GST burden, it would help us to understand why or if it is attributable to concerns about an increase in the recovery rate over time. If the latter, for some firms, the refinement in compliance techniques may have meant an increase in ITCs claimable, however, this is appropriate assuming the facts and circumstances support this. As well, the financial services sector in the past decade and a half has seen substantial changes due to deregulation, including in the cross-border arena, which has expanded their lines of business and may lead to more zero-rated exports. Furthermore, the trend within businesses and the federal and provincial governments themselves is towards a greater use of outsourcing

arrangements to be able to more quickly reduce fixed overhead costs in a downturn and to better focus on areas of competitive advantage – for some firms, this could also increase ITCs. Finally, for an industry that the Finance Minister has identified for greater international openness, one may expect or at least hope that free trade in securities will potentially lead to greater ITC recovery and thus an artificial cap is not reasonable.

The intention to move towards free trade in financial services is one of three changes announced in the 2007 federal budget, along with elimination of withholding tax on short-term debt and removal of interest deductibility on foreign-related loans, all of which will likely have a significant impact on the operations and organization of financial firms. We believe that the GST change may be sufficiently significant to warrant consideration with these three budget measures to ensure that Canadian capital markets remain competitive and can serve clients effectively.

Recommendation:

1. Defer enactment of the legislation until the community has an opportunity to understand and assess:
   - The rationale for and estimated financial effect – direct and indirect – of the changes on the securities sector as well as the explanation of how the 15-per-cent prescribed rate was reached
   - The consistency of the proposed changes with principles of a VAT and, from a level playing field perspective, comparable tax provisions in other Organization for Economic Co-operation and Development (OECD) countries
   - Alternative ways considered to achieve the benefits that Finance is seeking to obtain (e.g., listing allocation techniques that are *not* acceptable, Quebec proxy tax approach) and why they were rejected

2. As a minimum (and we appreciate that an election may be made to allow existing methodologies to be used until a new rate has been negotiated given that it is likely to be difficult for the CRA to meet the firms' requirement for timeliness at start-up):
   - Set a target timeline of six months for a recovery rate to be negotiated in future and establish an expedited three-month process when a restructuring occurs due to a merger, acquisition, etc.
   - Provide financial institution registrants with recourse to a binding CRA arbitration process (this also removes the conflict of interest caused by having to negotiate a rate with the CRA auditor)
   - Consider the processes in effect in other countries, for example, we understand, the United Kingdom.

Retroactivity and implementation time for application of the legislative changes

The legislation as drafted is retroactive in most areas to November 17, 2005 (with a clarifying amendment to the existing self-assessment provision applying from the day that provision first came into force, i.e., December 17, 1990). Retroactivity (except when the legislative intent regarding imported supplies was known) is contrary to the certainty that taxpayers require given that contracts will have been entered into without knowledge of the specific effect of the retroactive changes. As well, implementation time is needed for some of the more complex changes.

Recommendation: Amend the legislation to make the new provisions effective no earlier than the date of the release of the legislation and, in the case of amendments that require significant systems changes, at least a year after the date of enactment to allow for implementation of systems modifications; confirm that the transitional election will be available for all registrants.

Taxation of imported supplies

Proposed new section 217.1 has the effect of making taxable those services that are otherwise not subject to GST in Canada (namely labour costs and financial services), which is inconsistent with the GST from a tax policy perspective. Moreover, the draft legislation calls for backing out "loading" items – labour, insurance and similar otherwise-non-taxable items should be excluded from loading from the perspective of GST principles and because of the additional compliance costs. As well, the section 150 election for closely-related parties does not exist in the cross-border context, meaning that one legitimate form of relief is denied. Finally, value-added tax (VAT) paid on inputs to related third parties, which may already have lead to unrecoverable VAT being borne in another country by the related party, will become subject to further tax, leading to double taxation.

Recommendations:

1. Expand the section 150 election for closely-related parties or otherwise alleviate the inappropriate taxation of inputs that would not otherwise be taxable, including with respect to "loading"
2. Exclude items on which value-added tax has already been paid from being subject to a VAT (GST) a second time
3. Do *not* require another schedule to be created and require payments to be made at a different time.

Annual reporting form

Financial institutions, including our members, have invested considerable time and money in developing methodologies, systems and processes to capture what is reasonable to satisfy auditors for GST purposes. These development and ongoing compliance costs are on top of the estimated $135 million in unrecoverable GST paid by our members annually. The changes under consideration appear extensive, despite the statement that the data should be readily available (in fact, we believe that the CRA already has access to some of the data), and we are unsure that the value to be derived exceeds the costs to be incurred.

The purpose of consultations regarding the schedule were threefold and we believe that all three goals can be met better or as well through approaches that do not require major systems changes or a permanent increase in staff resources unless Finance and/or the CRA can demonstrate otherwise:

1. Stated goal – assessing policy and legislative changes: We believe that before new forms are required, the information that Finance or the CRA would like should be sought in less intrusive ways
2. Stated goal – tax administration purposes: We would appreciate an understanding of the expected impact of the proposed schedule changes on the time and cost of audits for the CRA and registrants; the Finance/CRA sales tax presentation cited ease of industry compliance as a benefit and we are not clear from what basis this view is derived
3. Stated goal – sales tax harmonization: We appreciate the benefits to most parts of the economy to accrue from sales tax harmonization – as harmonization will increase financial institutions' direct burden, we believe that the federal and provincial governments must develop a simple and straightforward approach to allocate the net proceeds from the industry among the different jurisdictions.

We understand that a number of the banks are engaged in a pilot project to assess the feasibility of the new form and will be interested in the findings of this effort. As the IIAC represents both larger and smaller firms, we believe that an assessment should also be made from the perspective of small securities firms. The government has expressed its intention, most recently in the March 19, 2007 budget, to reduce the regulatory burden on small businesses and we assume that this philosophy will apply in the case of the GST.

Recommendations:

- Circulate the results of the analysis conducted by the banks in the pilot project and allow time for analysis and discussion
- Review the application of the information schedule to entities caught under paragraph 149(1)(b) of the *Excise Tax Act* and those that have filed a section 150 election where, we understand, concerns have been expressed
- Arrange a meeting with Finance and the CRA with HST provinces and industry representatives to discuss the proposed annual return changes and possible ways to simplify what is set out as required
- If the new annual return is to proceed in any event, review the implementation deadline (we recommend at least 12 months after Royal Assent for implementation), providing six months following fiscal year-end to complete the return as it uses data collected to complete the corporate income tax returns that is due within six months of fiscal year-end
- Allow amended returns to be filed to correct information in order to avoid complications for firms and the CRA of having to file in the subsequent year.

Other

Recommendations:

- Provide the financial institutions with a right of appeal to the CRA on issues applicable to administration of the GST
- Provide that the six per cent penalty is not automatic and applies only in cases of fraud or continuous evidence of negligence.

In conclusion, we believe that the benchmarks by which the changes are assessed should be: are they fairer, are they simpler (or not materially more complex), are they cost-effective and do they provide greater certainty than what they replace – do benefits outweigh costs? We recognize that we may not be in possession of all the facts, but at this point do not believe that we can say that the changes measure well against these benchmarks and that there is a significant possibility that Canadian financial institutions may be:

- On a less level playing field than currently vis à vis international firms in Canada and outside Canada, as well as vis à vis non-financial entities such as consultants, that compete in the domestic context (advisory services, merger and acquisition advice)
- Subject to greater complexity (new definitions such as procurative and operative extent; exclusive and excluded inputs; prescribed percentage and class; loading; qualifying compensation, consideration, service and taxpayer; and a number of new formulas as well as provincial breakdowns), the costs of which may well exceed any net economic benefits
- Greater uncertainty in the period that recovery rates are being negotiated.

The IIAC looks forward to a meeting with Finance on these issues in the near future.