LFC-NGO-CD-NS-MC

GST & COMMODITY TAX

Today's leading thinking on GST, Customs, PST and related taxation issues

Editor: Jim Day, C.A. • Ryan • email: jim.day@ryan.com

April 2012 **Vol. XXVI No. 3**

GST/HST CASES

THE CIBC WORLD MARKETS SAGA: SETTLEMENT OFFERS AND COSTS CONSEQUENCES

Robert G. Kreklewetz & John Bassindale
Millar Kreklewetz LLP (Toronto)
rgk@taxandtradelaw.com, jgb@taxandtradelaw.com

CIBC World Markets has proven to be the case that keeps on giving to tax practitioners — providing interesting decisions from both the Tax Court[1] and the Federal Court of Appeal.[2] In this final chapter, the Federal Court of Appeal ("FCA") rules on a motion by CIBC World Markets under Rule *403* of the *Federal Court Rules* for higher than normal costs.[3] The decision of the FCA on this costs motion will be of interest to all tax litigators.

1 *CIBC World Markets Inc. v. R.*, 2010 CarswellNat 5197, 2010 CarswellNat 3188, [2010] G.S.T.C. 134 (T.C.C. [General Procedure]).
2 *CIBC World Markets Inc. v. R.*, 2011 CarswellNat 4618, 2011 CarswellNat 3848 (F.C.A.).
3 *CIBC World Markets Inc. v. R.*, 2012 CarswellNat 33 (F.C.A.).

IN THIS ISSUE

CARSWELL®

THOMSON REUTERS

CARSWELL®

One Corporate Plaza, 2075 Kennedy Road,
Scarborough, Ontario M1T 3V4
Tel: (416) 609-3800 from Toronto
1-800-387-5164 from elsewhere in Canada/U.S.
Internet: http://www.carswell.com
E-mail: www.carswell.com/email
ISSN 0847-3528

Publications Mail Agreement #1410180
PAP Registration #8919

The Relevant Facts

While the facts upon which the case itself is based are rather complicated (and have been dealt with in some detail in previous articles[4]), the facts which are relevant to the costs motion are much more simple.

CIBC World Markets Inc. ("CIBC") made an offer to settle on June 30, 2009 for 90% of the total amount of tax at issue. This offer held no expiry date, and was therefore capable of acceptance at any time. The TCC hearing took place on February 10, 2010, and by decision dated September 8, 2010, the appeal was dismissed with costs against CIBC. The FCA heard the case on September 21, 2011, and rendered their decision on September 30, 2011, allowing the appeal and awarding CIBC costs in both the FCA and the TCC. The case itself involved a question of law and, therefore, the decision of each court was necessarily an "all or nothing" result for CIBC.

After succeeding in the FCA, CIBC moved for an order directing the FCA's assessment officer to award higher-than-normal costs for *both* the proceedings before the TCC and the proceedings before the FCA.

The Positions of the Parties

CIBC's motion for higher-than-normal costs relied on the unaccepted written offer to settle, such written offers being one of several factors a court may consider in determining the amount and allocation of costs under Rule *400* of the *Federal Court Rules*.

The Crown rejected CIBC's position, contending that it had been legally powerless to accept CIBC's settlement offer and, therefore, no cost consequences should flow from the Crown's failure to accept the settlement offer. More specifically, the Crown argued that it was not permitted to accept a settlement offer unless it was supported on the facts and law of the particular case. In this particular case, the "all or nothing" nature of the legal issue meant that an arbitrary compromise based on quantum (e.g., 90% of the amount at issue) could *never* meet this requirement.

The Decision of the FCA

Costs in the Federal Court of Appeal

The FCA rejected CIBC's request for higher than normal costs related to the FCA decision out of hand because CIBC had not reasserted its offer to settle after the decision of the TCC. On this point, the FCA cited prior case law from the FCA, ABCA, and ONCA which clearly set out that "an offer of settlement made before the decision at first instance does not affect the award of costs on appeal, unless the offer is reasserted while the appeal is pending."

While litigators often make settlement offers for the purpose of protecting the final cost awards, many litigators may not be aware of the requirement to reassert the offer to settle on appeal. This point is important for all litigators to know — not just tax litigators.

Evidence in Support of Motion

As part of CIBC's motion record, it provided the letter setting out the offer to settle. Normally, this would not cause any issues if the letter merely contained the settlement offer. However, the letter also set out some of the comments and opinions of the Tax Court judge who presided over the pre-hearing conference.

The Crown submitted that such comments and opinions were not subject to disclosure, and should therefore be disregarded by the FCA. The FCA agreed with the Crown, and reaffirmed that the content of the pre-hearing conference could not be introduced in the costs submission. While the settlement offer itself necessarily had to be disclosed for the purpose of the motion, references to what was discussed or proposed during the pre-hearing conference and the comments of the presiding justice should have been redacted.

4 See Robert Kreklewetz and John Bassindale, "Bittersweet Victory for CIBC World Markets", *GST & Commodity Tax*, Vol. XXV, No. 10, December 30, 2011 and Robert Kreklewetz and John Bassindale, "No Changes Permitted to ITC Allocation Methods After Filing", *GST & Commodity Tax*, Vol. XXIV, No. 6, October 16-31, 2010.

While costs submissions always involve the disclosure of privileged documentation in the form of the settlement offer, litigators should understand the limits of this required disclosure – only the settlement offer itself can be introduced, and the privileged circumstances and discussions surrounding the offer should *not* be disclosed on a subsequent costs submission.

Could the Crown Have Accepted the Settlement Offer?

The FCA considered whether, as a matter of law, the Crown could have accepted CIBC's settlement offer. The FCA first agreed with the Crown's submission that, given the circumstances of the case, the issue was an all or nothing proposition for both CIBC and the Crown. There was, therefore, no factual or legal basis on which a compromise settlement could be based.

The FCA next considered the Crown's power to accept such compromise settlements which cannot be supported by the facts and law. The FCA reviewed prior decisions on this issue, including *Galway*,[5] *Cohen*,[6] and *Harris*,[7] and held that it was bound by these prior unanimous decisions. In the FCA's view, the Minister of National Revenue was obligated to assess "on the facts in accordance with the law and not to implement a compromise settlement." As stated in *Galway*: "the Minister of National Revenue is limited to making decisions based solely on considerations arising from the Act itself."

The FCA distinguished the cases cited by CIBC as representing situations where the settlement involved agreed upon facts, and noted that such agreements, as to disputed facts, were not contrary to the principle in *Galway*.

CIBC attempted to argue that policy considerations should permit settlement, if for no other reason than to prevent most tax cases from being litigated to trial. The FCA, however, was not very concerned about this possibility, and instead noted that, despite *Galway*, tax litigation has continued to result in settlements over the past 35 years, and that often times new facts are brought to light, or different appreciations of the law may emerge resulting in settlements that the Minister *can* agree to, based on the facts and the law at hand.

In concluding, the FCA noted that there was a "forest of policy arguments," both in favour of and against compromise settlements by the Minister, and that Parliament should determine the best route out of that particular forest.

The FCA, therefore, ordered that no special cost consequences could flow from the CIBC settlement offer, and dismissed the motion, with costs to the Crown.

Commentary

While the decision of the FCA is undoubtedly technically correct insofar as the analysis of the *Excise Tax Act* is concerned, it would have been nice if the FCA's reasoning addressed the question of the proper interpretation of section 5(d) of the *Department of Justice Act* which, in our view, might reasonably have been interpreted as providing Crown Counsel (as delegates of the Attorney General of Canada) with the express authority to settle litigation matters and bind the government, even in the case of a compromise settlement.

Section 5(d) of the *Department of Justice Act* provides that the Attorney General of Canada "shall have the regulation and conduct of all litigation for or against the Crown or any department, in respect of any subject within the authority or jurisdiction of Canada." This power over the regulation and conduct of all litigation should arguably not be limited, except by explicit legislation. It is open to interpretation how broad a power the Attorney General of Canada is given, and whether it is empowered to effect closure to litigation, even against the wishes of its "client". Unfortunately, this section does not appear to have been addressed by the FCA in the decisions noted above.

Another factor that has been surprisingly absent from this line of analysis is that, in practice, the Minister of National Revenue settles a great many tax cases on a somewhat less than "all or nothing" basis — and with Crown Counsel brokering these real-world settlements. If the Crown is indeed powerless to accept pure compromise settlements in tax cases, one certainly has to wonder about that.

It was not that long ago that we received a call on an important tax case for Canadian importers, where the most senior Crown Counsel in Toronto (now retired) called to offer to settle the matter on an 80-20 basis for our client. Our client ultimately rejected the offer and the matter was settled, on the eve of trial, at 100 cents on the dollar for our client. With that in mind, one wonders what practical impact the decision of the FCA may have on future settlement offers.

5 *Galway v. Minister of National Revenue*, 1974 CarswellNat 186, 1974 CarswellNat 352, [1974] C.T.C. 454, 74 D.T.C. 6355 (Fed. C.A.).

6 *Cohen v. R.*, 1980 CarswellNat 252, [1980] C.T.C. 318, 80 D.T.C. 6250 (Fed. C.A.).

7 *Harris v. R.*, 2000 CarswellNat 1047, 2000 CarswellNat 1048, [2000] 3 C.T.C. 220, 2000 D.T.C. 6373 (Fed. C.A.).

GST/HST CASES

DIRECTORS CANNOT PUT THE BLAME ON THE CRA'S COLLECTION EFFORTS

Jeanette Wang
Legacy Tax + Trust Lawyers
JWang@legacylawyers.ca

The Federal Court of Appeal ("FCA") has confirmed in *Barrett v. The Queen*[8] that the Minister of National Revenue only has to make a good faith effort to search for assets of a corporate debtor as a precondition to the issuance of a director's liability assessment.

Background

The corporation in *Barrett* had failed to remit GST in the amount of $128,696 prior to ceasing operations in 1995. The Minister's collection efforts proceeded slowly. The corporation's GST debt was not certified in Federal Court until 1998. Two years went by before a sheriff was directed to execute a writ of seizure and sale, which was returned unsatisfied. Nearly another three years went by before the director was assessed in September 2003 for the corporation's GST liability.

8 *Barrett v. R.*, 2012 CarswellNat 168 (F.C.A.).

The director did not argue due diligence. Rather, the director argued that the Canada Revenue Agency ("CRA") was not diligent in its collection efforts. The CRA's collection efforts consisted of inquiring with the director about what corporate assets there were, conducting searches for personal property, registering a writ of seizure and sale, and directing the sheriff to enforce the writ. No assets were found and, therefore, the CRA went after the director. It turned out that the company did have assets, as the director led evidence in Tax Court that, in 1995, the company had over $230,000 in cash in its bank account, $270,000 in stocks and bonds, and liabilities of under $175,000. This contradicted the evidence of a CRA collection officer, in which the director had told the CRA that the company had no assets and no ability to pay the GST liability in 1995. The director acknowledged that he subsequently used up the corporate assets to pay for a divorce, to pay for his kids' university education, and to invest in a friend's business.

A director's liability for a corporation's GST liability is imposed under section *323* of the *Excise Tax Act* (the "Act"). Before a director can be made liable, paragraph 323(2)(a) of the Act requires the Minister of National Revenue to register a certificate for the amount of the corporation's liability in Federal Court and that execution for the amount be returned unsatisfied. The purpose of this paragraph, as noted by the FCA, is to protect directors, as it basically requires the Minister to recover the GST debt from the corporation before pursuing the directors for payment.

Chief Justice Bowman considered paragraph 323(2)(a) in *Miotto v. the Queen*,[9] which was also a director's liability case, in which he commented that the execution of a writ requires reasonable efforts on the part of a bailiff. The Tax Court interpreted the Chief Justice's comments as requiring the Minister to make reasonable efforts to locate assets of a debtor under paragraph 323(2)(a). The evidence before the Tax Court suggested that the CRA had not conducted a search for the company's bank account prior to the return of the writ of seizure and sale. Because the CRA failed to locate this bank account, which apparently had $230,000 in cash when the company had ceased operations, the Tax Court concluded that the CRA had failed to exercise reasonable efforts to execute the writ of seizure and sale. For this reason, the Tax Court allowed the appeal and vacated the assessment.[10]

FCA Analysis and Decision

The FCA did not agree with the Tax Court's interpretation of Chief Justice Bowman's comments in *Miotto*. The FCA noted that the Chief Justice had remarked that it took a "certain amount of nerve" for the directors in that case to criticize the bailiff, and the CRA for being remiss in failing to find assets of the company when in fact it was the directors themselves who were responsible for the disappearance of the company's assets. The same comments could apply to the director in *Barrett*, given that he had misled the CRA into believing that the company had no assets to pay the GST debt when, in fact, the company had assets which the director subsequently used for personal expenses.

The FCA held that Tax Court Justice Gaston Jorre erred in his interpretation of paragraph 323(2)(a). The FCA concluded that paragraph 323(2)(a) of the Act only requires the Minister to exercise good faith in locating assets of the debtor, and that there is no obligation on the Minister to make reasonable efforts. As there was no evidence that the Minister in this case did not exercise good faith in failing to locate the company's bank account, the judgment of the Tax Court was set aside.

The decision of the FCA goes to show that if the CRA fails to locate assets of the company to satisfy its tax debts (when the director is responsible for depleting those assets), the director cannot turn around and accuse the CRA of not looking hard enough for those same assets.

GST/HST LEGISLATION

THE COMPLEXITIES OF BASIC GROCERIES

Under the *Excise Tax Act* ("ETA"), most goods and services supplied in Canada are taxable for GST/HST purposes. Items that escape these taxing provisions are those that are zero-rated (i.e., taxed at a rate of 0%) or exempt (i.e., outside the scope of the tax). Basic groceries are zero-rated for GST/HST purposes. By definition, this includes most supplies of food and beverages for human consumption, which are generally products consumed to sustain or maintain life, or to alleviate hunger or thirst. However, this definition specifically excludes certain foods and beverages that are generally viewed as luxury items and are, therefore, subject to GST/HST. These excluded items largely include products such as alcoholic beverages, soft drinks, candies, confections, and certain snack foods.

Over the years, the introduction of a variety of new, complex, and/or improved grocery items has challenged the basic grocery zero-rating provisions, making it harder to determine the tax status of certain products. Since the implementation of the legislation in 1990, the Canada Revenue Agency ("CRA") has issued many headquarters letters and interpretations addressing the application of GST/HST to various food and beverage items. In addition, there have been several interesting court cases where taxpayers have challenged the CRA's position and tax assessments in relation to products they feel should be zero-rated. These situations clearly indicate that the application of the "basic groceries" provisions is not as straightforward as one would hope.

Legislation

Section 1, Part III, of Schedule VI to the ETA defines zero-rated basic groceries as "supplies of food or beverages for human consumption (including sweetening agents, seasonings and other ingredients to be mixed with or used in the preparation of such food or beverages) other than supplies of ...". The legislation goes on to list certain items specifically excluded from zero-rating and outlined in paragraphs (a) to (r). The legislation is generally intended to zero-rate products marketed for the purpose of nourishing the human body. However, given the long list of exclusions, it seems to be more important to not be caught by an exception, rather than fall into the very broad definition of a basic grocery. One such exclusion, paragraph (b),

9 *Miotto v. R.*, 2008 CarswellNat 628, 2008 CarswellNat 3135, [2008] G.S.T.C. 70 (T.C.C. [General Procedure]).

10 [Ed. For further commentary on the TCC decision, see Jeanette Wang, "Another Argument for Directors to Challenge Director's Liability Assessments", *GST & Commodity Tax*, Vol. XXIV, No. 5, October 1-15, 2010.].

exempts non-carbonated fruit beverages, other than milk-based beverages, containing less than 25% natural fruit juice by volume from zero-rating. Another interesting exception, under paragraph (h), specifically removes granola products from zero-rating, with the exception of granola products sold primarily as breakfast cereal. Yet another complex exclusion, under paragraph (m), excludes cakes, doughnuts, muffins and other pastry items with sweetened filling or coating from zero-rating, but does not excludee such items if they are prepackaged or sold to customers in quantities of six or more. Bread products, such as bagels, are not excluded from zero-rating under the latter paragraph.

This section of the ETA was amended in 1997. The amendments included specific reference to juice bars and similar products excluded by paragraph (j), and non-dairy substitutes for ice cream and similar products already listed in paragraph (k), as exclusions from zero-rating when packaged as single servings. Paragraph (k) was updated to also exclude items sold in single servings, rather than just packaged in single servings, from zero-rating. Perhaps the most significant change, however, was made with respect to "prepared foods in a form suitable for immediate consumption." While retaining the exclusion from zero-rating for food and beverages that are heated for consumption, three new paragraphs were added to exclude: salads that are not canned or vacuum sealed (paragraph o.1); non-frozen sandwiches and similar products (paragraph o.2); and food or beverages sold under a contract or in conjunction with catering services (paragraph o.5).

As a further guide to applying the legislation, GST/HST Memoranda Series 4.3, "Basic Groceries" ("GMS 4.3"), is available. While this administrative policy does not replace the legislation, it provides fairly detailed direction on how the CRA believes GST/HST applies to basic grocery products. The memorandum also provides guidance on more complex situations that are not explicitly addressed in the legislation, including cultural foods, vitamins, food additives, dietary supplements, meal replacement products, product labeling, and mixed supplies.

Areas of Complexity

Supplied for Human Consumption

As basic groceries are defined to include food marketed for human consumption, it is reasonable to exclude from this definition products not intended to be ingested by humans and products that do not meet the minimum standards of the Canadian Food and Drug Administration. Substandard food and food waste commonly supplied for use as animal feed, are examples of items that would not qualify for zero-rating under the basic groceries provisions. Similarly, salt that is supplied solely for industrial use, such as de-icing salt for roads and salt used for water softening, is also excluded. However, table salt, salt for curing fish, and pickling salt are zero-rated as basic groceries where they are packaged for sale for human consumption. Unfortunately, many situations are not as clear cut or obvious as these examples. The issue of whether a food product is considered to be a supply of food to be consumed for the purpose of sustaining or maintaining life, or for alleviating hunger or thirst, has often been addressed by the courts.

In the case of *Kandawala,*[11] at issue was whether paan is an item supplied as "food for human consumption", and if so, whether it is excluded by any of the exceptions listed in paragraphs (a) to (r). Paan is a leaf imported from India. It is sold in Canada in a ready-to-consume form and is often eaten after meals to aid in the digestion of food and to help freshen breath. Paan leaves are also used in prayers in the Hindu religion and later discarded. In the view of the Minister, paan is not a basic grocery item, but rather a taxable non-essential food item excluded as either a confectionary item or a snack food.

The Court ruled in favour of the Minister, dismissing the Appellant's appeal that paan leaves should be zero-rated. Prior to presenting his decision, Justice Rip reviewed a number of relevant cases, including the matter of *Vincent Chow and Her Majesty the Queen,*[12] where the Appellant was assessed for failure to collect and remit GST on its supply of Chinese herbs. These herbs were sold both in solid and liquid form. They could be purchased as a tonic, an ingredient for soup, or applied externally as an ointment or dressing to reduce pain or heal cuts and bruises. It was the Minister's position that these herbs were not consumed for nourishment as a basic grocery item, but rather for their actual or perceived medicinal properties. From this case, the word "consumption" was found to mean "the action or fact of consuming or destroying." The meaning of the word "food" was defined as "what is taken into the system to maintain life and growth, and supply the waste of tissue; ailment, nourishment, provisions, victuals."

Based on the evidence presented, the Court dismissed the Appellant's case on the grounds that the herbs were both sold and purchased as medicinal products to restore or preserve health, and not as food to maintain life. In addition, it was found that the way in which the herbs were used did not meet the definition of consumption. Similarly, when "eaten", paan is neither consumed nor destroyed. It is usually chewed after a meal and only the secretions of the leaf are ingested, while the leaf itself is spat out after chewing. For these reasons, paan and similar products that are not consumed or destroyed when chewed, do not generally qualify as zero-rated basic groceries.

Can an argument be made that paan leaves should be zero-rated in a manner similar to bay leaves? Bay leaves, when purchased for use in cooking, are zero-rated as ingredients, even though the leaf itself must be removed before the food is eaten. Paragraph 143 of GMS 4.3 explains that "supplies of ingredients to be mixed with or used in the preparation of food and beverages for human consumption are zero-rated." The fact that paan leaves are often used as non-food items in religious ceremonies or used after a meal, rather than during the preparation of a meal, would appear to distinguish them from ingredients such as bay leaves.

Could paan qualify for zero-rating under the interpretation in paragraph 146 of GMS 4.3? This paragraph states:

> products which are not generally recognized as food or beverages in Canada, which are consumed as food or beverages by cultural groups, are considered zero-rated basic groceries unless the food

11 *Kandawala v. R.*, 2004 CarswellNat 3378, [2004] G.S.T.C. 131 (T.C.C. [Informal Procedure]).

12 *Vincent Chow White Crane Martial Arts Ltd. v. R.*, 1999 CarswellNat 1396, [1999] G.S.T.C. 67 (T.C.C. [General Procedure]).

or beverages are specifically excluded from zero-rating under the provisions of paragraphs 1(a) through 1(r) of Part III of Schedule VI. However, the products must be consumed as basic grocery items for nourishment (as opposed to products consumed for actual or perceived medicinal properties).

This paragraph is essential when reviewing the tax status of food and beverage products associated with various cultural groups, since "the CRA considers a product to be food and beverage if an average consumer would recognize and purchase the product as such in the ordinary course of buying basic groceries."[13] It would not be equitable to exclude certain cultural food and beverage items from zero-rating solely because an "average" Canadian consumer may not purchase them during a typical trip to the grocery store. Therefore, this paragraph allows for the zero-rating of imported foods and beverages that are: (1) not considered luxury items, soft drinks, alcoholic beverages, candies, confections or snack foods; and (2) consumed for nourishment rather than medicinal purposes.

Paragraph 146 did not affect the outcome in the *Kandawala* case because, in order for the policy to apply, the product in question must first be "for human consumption" and cannot be excluded from zero-rating by paragraphs (a) to (r). Since paan is viewed as *not* for human consumption, paragraph 146 of GMS 4.3 (i.e., the CRA's administrative policy) did not apply.

From the various cases reviewed by Justice Rip, the following list of useful factors for determining whether a particular food item is zero-rated was derived:

(a) whether the item in question is specifically exempted by the enumerated list of exceptions found in Part III of Schedule VI to the Act;

(b) whether the item is one which would reasonably be considered a convenience food;

(c) whether the item is intended to be consumed immediately after opening or removing the packaging;

(d) whether the item requires the consumer to undertake additional preparation prior to consumption;

(e) whether the item is one which will be consumed (as opposed to, for instance, something that will be applied externally);

(f) whether the item is one that has traditionally been thought of as a basic food item;

(g) whether the item bears the attributes one normally associates with food (i.e., it is tasteful, its packaging displays a list of ingredients, it assuages hunger, etc.).

The analysis of each product will be different. However, these factors provide a useful starting point.

Product Marketing

From the inception of the GST, the government's intention was to not subject basic groceries to tax. The structure of the legislation does not define what is included in basic groceries; rather, it provides a framework for determining which products are excluded from zero-rating and are, therefore, taxable at the normal rate according to the place of supply. However, sometimes the distinction between an otherwise taxable item and a zero-rated item may not be easily determined. The CRA has always taken the position that, if a product's tax status is in doubt, the manner in which the product is displayed, labeled, packaged, invoiced, and advertised will be considered in determining its tax status.[14]

Although no one factor should be used to determine the nature of a product, these factors may provide an indication that the product is consumed for enhancement purposes, and not as a food product. Paragraph 160 of GMS 4.3 explains that meal replacement products and nutritional supplements are considered zero-rated basic groceries. The purpose of these products is to provide nourishment to the human body. However, dietary supplements consumed for therapeutic or preventative measures, or to achieve specific beneficial effects related to performance or physique, are taxable.[15] Since these two types of products may appear very similar, the distinction is often best determined based on the claims, warnings or ingredients on the packaging, or on how the product is marketed. In addition, it should be noted that the manner in which a product is sold may change its tax status. For example, all supplies of meal replacements, nutritional supplements, and formulated liquid diet products are zero-rated. However, when these items are sold from a vending machine, they become taxable.[16]

1146491 Ontario Ltd. and Her Majesty the Queen[17] provides an excellent illustration of the complexities surrounding the application of the zero-rating provisions for basic groceries. Among other things, this case looks at issues involving prepared foods and product marketing. The main concern in this case was whether the Appellant was correctly assessed for failure to collect tax by the Minister based on paragraph o.1, which specifically excludes from zero-rating "salads not canned or vacuum sealed." The products in question were salad kits in zip-lock bags, with separate bags for cheese, bacon bits, croutons, olives and onions, and containers for dressing included inside. The Minister's position was that, because the product is a salad and not canned or vacuum sealed, it was excluded from zero-rating as clearly outlined in paragraph o.1. Conversely, the Appellant's position was that a salad kit is not a salad, but rather a basic grocery item and, therefore, should remain eligible for zero-rating. The court ruled in favour of the Appellant and granted the appeal.

In the view of the Minister, the salad kits were packaged and marketed as prepared salads. Rather than requiring a customer to separately purchase the ingredients required to prepare a salad, a salad kit provides all of the ingredients, appropriately measured, in one package. The Appellant's website advertised "ready-made salads" and "toss-and-serve salad kits." However, it is clear from this case that the Minister saw little difference between a prepared salad and a combined supply of zero-rated ingredients. In support of its position, the Minister presented the issues of immediate consumption and the convenience of purchasing a salad kit. These points were considered by Justice Miller, who acknowledged that

13 GST/HST Memoranda Series 4.3, "Basic Groceries", paragraph 2 ("GMS 4.3").

14 GMS 4.3, paragraph 1.

15 *Ibid.*, paragraph 148.

16 *Ibid.*, paragraph 160.

17 *1146491 Ontario Ltd. v. R.*, 2002 CarswellNat 1056, 2002 CarswellNat 5004, [2002] G.S.T.C. 54 (T.C.C. [General Procedure]).

salads are – at least to a certain degree – prepared food items. Although salad kits had an element of convenience, they were not the same as a fully assembled salad. Further, they were not the same as prepared sandwiches, food platters, and catered meals (as listed in paragraphs o.1, o.2, o.3 and o.5), which typically require no preparation at all. To this end, the judge made the following remark:

> *In this fast-paced day and age, where retailers market convenience to households, in which spending more than one half hour on food preparation is a rare luxury, it is inappropriate to find a salad kit not to be part of basic groceries. Those steeped in culinary arts might pooh pooh the idea that assembling a Caesar salad from a salad kit constitutes food preparation or cooking. I have no doubt there are a far greater number, be they university students, law clerks, young urban professionals or retired couples who think the assembly of the salad from the kit is indeed cooking. As such, the kit itself cannot be considered the salad.* [18]

The Court's decision took into consideration the overall substance and intent of the salad kits — ingredients to make a salad — rather than how they were physically packaged (i.e., the salads were not canned or vacuum sealed). In arriving at this conclusion, the following factors about the case were also considered:

- the bag is labelled as a kit, not a salad;
- in Market Fresh's advertising, ready-made salads were distinguished from the salad kits;
- the serving is not a single serving but multi-servings;
- not all the contents of the package need to be used in one sitting, but can be re-sealed for a subsequent meal;
- the content cannot be consumed on the spot;
- the package must be brought home, as a bowl and utensils are required to assemble the salad;
- although there is an element of convenience to the kit, it is not to the extent of a fully assembled salad;
- the common sense approach would be to differentiate between a salad and a salad kit; [and]
- the characteristics of the salad kit do not match the characteristics of the other exceptions in subsection 1(o.1) of Part III of Schedule VI of the Act.

Another equally interesting decision is the case of *Complete Cuisine & Fine Foods To Go (1988) Ltd.*[19] In this case, the Appellant provided meals for its customers which were partially cooked. These meals needed to be further cooked by conventional oven or microwave before they could be eaten. The CRA assessed the Appellant for not collecting and remitting GST on what it considered to be fully prepared, non-frozen meals. The CRA took the position that the Appellant was providing catering services (under paragraph o.5) that were taxable at a rate of 7% (the rate in effect at that time). However, in the view of the Court, the supplier did not provide "catering services", but merely the delivery of zero-rated food items. The fact that the product had to be further cooked before it could be eaten, is consistent with the distinction drawn between "food" and "prepared food" in other cases. In addition, there was no evidence presented to show that the supplier provided a service of serving ready-to-eat prepared food. Accordingly, the taxpayer's appeal was allowed.

The complex nature of the basic grocery provisions has also resulted in numerous requests for Headquarters GST/HST Rulings letters. One recent request was for a ruling on the tax status of fruit bars.[20] The facts in this letter indicate that the product is composed of dried fruit and spices compressed into a rectangular bar. It is individually wrapped and packaged in a box containing at least six items. In a typical supermarket, the product is displayed with nutritional, protein and energy bars. In addition, the label on the packaging implies that the product may qualify as a meal replacement or nutritional supplement. Based on the information provided, the position of the CRA is that this product is excluded from zero-rating. In the CRA's response, the following paragraphs from GMS 4.3 were considered:

- Paragraph 62 – In this paragraph, granola bars, but not including products sold primarily as breakfast cereal, are excluded from zero-rating. The taxpayer's product did not qualify as a cereal bar because it does not contain cereal and is not marketed as a breakfast cereal bar.
- Paragraph 87 – Certain food products sold in quantities of six or more may be zero-rated under this paragraph. However, this paragraph is specifically for sweetened goods, such as cakes, muffins, pies, pastries, tarts, cookies, doughnuts, brownies, and croissants with sweetened filling or coating. Since the taxpayer's product is not a sweetened good, this paragraph could not be applied.
- Paragraph 162 – Energy bars and protein bars that qualify as meal replacements and nutritional supplements are zero-rated under this paragraph, except when sold from a vending machine. *The Food and Drug Act and Regulations* set out conditions that must be met in order for a product to qualify as a nutritional supplement or a meal replacement. Although the taxpayer's product has packaging which indicates a meal replacement or a nutritional supplement, it is not fully marketed as such and, therefore, does not qualify for zero-rating.
- Paragraph 85 – This paragraph specifically excludes fruit bars, rolls, or drops or similar fruit-based snacks foods from zero-rating. With fruit as the main ingredient in the taxpayer's product, the CRA determined that the product is excluded from zero-rating under this paragraph.

Conclusion

As product innovators continue to explore and introduce new food products, many of which are not specifically addressed by the current legislation, the ability to define the nature and tax status of certain items may continue to be a challenge for taxpayers and tax authorities. However, as demonstrated through the cases and interpretations presented above, two key points to consider when applying the legislation to certain food products are: 1) whether the product is actually consumed; and 2) how the product is packaged, labeled, and marketed for sale.

18 *Ibid.*

19 *Complete Cuisine & Fine Foods To Go (1988) Ltd. v. R.*, 2003 CarswellNat 967, 2003 CarswellNat 5915, [2003] G.S.T.C. 81 (T.C.C. [Informal Procedure]).

20 GST/HST Headquarters Letter, Document No. 128489, March 21, 2011.

GST CASES

VOIP TELECOMMUNICATION SERVICES PROVIDED TO NON-RESIDENTS MAY BE ZERO-RATED

Caroline Desrosiers and Nicolas Simard
Spiegel Sohmer, Montreal
NSimard@spiegelsohmer.com, CDesrosiers@spiegelsohmer.com

In *SWS Communication Inc. et al v. The Queen*,[21] the Appellants, Centre les Voyages Miracle Inc. and SWS Communication Inc. (the "Taxpayers") were operating in the telecommunication industry as wholesale Voice Over Internet Protocol ("VOIP") providers. VOIP technology is used to provide telecommunication services, such as Skype, long distance calls over the internet and online gaming, and is a huge and growing industry. As VOIP providers, the Appellants negotiated pricing agreements with telecommunication carriers all over the world for the transmission of VOIP communications initiated by the Appellants' clients. In turn, the Appellants would offer those negotiated Internet paths to other wholesalers with a slight mark-up on the rate negotiated.

The Taxpayers were reassessed for their alleged failure to collect GST on the supply of telecommunication services rendered to BMT America LLC ("BMT") and Convergia Inc., both U.S. based corporations.

Based on the evidence provided, the services rendered to BMT were for calls originating in the U.S. to termination points outside of Canada. A U.S. based server was used to provide the services. A second server located in Montreal was used exclusively as a back-up. Since the U.S. server did not fail during the audited period, the back-up server was never used to complete the calls and, hence, did not render the services.

The primary issue in this case was whether the VOIP services supplied were zero-rated under section 22.1 of Part V of Schedule VI of the *Excise Tax Act* ("ETA"). In general terms, this section provides that a supply of telecommunication services is zero-rated when the services are rendered to a non-resident, non-registrant, who acquires the services for use outside of Canada.[22] The Crown argued that the Appellants could not benefit from this exception because the services were rendered to deemed residents, pursuant to subsection *132(2)* of the ETA, which provides that a non-resident who has a permanent establishment in Canada is deemed resident in respect of activities carried on through that establishment.

The Court decided that BMT and Convergia Inc. did not receive the VOIP services in relation to their permanent establishments in Canada because the services were not consumed or used in the activities carried on through those permanent establishments.

The Court also addressed the burden of proof in tax cases and reaffirmed the principle that the Minister's assumptions must be specifically pleaded in order for the onus to be shifted to the Appellant. The Court held that it was not sufficient for the Minister to assume that the recipient of the services had a permanent establishment in Canada for the purposes of determining whether there was a deemed residence in Canada. In order for the deemed residence created by subsection 132(2) to apply, the Crown had to demonstrate that the services were provided in furtherance of the activities carried on through the permanent establishments located in Canada. Since the Crown failed to assume and allege that the Appellants provided services to Canadian permanent establishments for use in a business carried on in Canada, the assumptions of the Crown were not sufficient to support the assessment on the basis that the services did not qualify for zero-rating.

Additionally, Justice Hogan refused to disqualify an expert witness from also testifying as a factual witness on elements for which he had personal knowledge, on the basis that he was called to testify as an expert.

THUMBTAX

2012 International Tax Seminar, International Fiscal Association Canada, May 17 to 18, 2012, Ottawa, Ontario, *www.ifacanada.org*.

Advanced Sales and Use Tax Workshop, Sales Tax Institute, May 21 to 23, 2012, New Orleans, Louisiana, *www.salestaxinstitute.com*.

Prairie Provinces Tax Conference — Keeping Tax Practitioners Informed, Canadian Tax Foundation, May 28 to 29, 2012, Winnipeg, Manitoba, *www.ctf.ca*.

In-Depth GST/HST Course, Chartered Accountants of Canada, May 27 to June 1, 2012, Niagara Falls, Ontario, *www.cica.ca*.

2012 FEI Canada Conference — Rock Solid Success, Financial Executives International Canada, June 6 to 8, 2012, St. John's, Newfoundland, *www.feicanada.org*.

Advanced GST/HST: Financial Services Course, Chartered Accountants of Canada, June 14 to 15, 2012, Toronto, Ontario, *www.cica.ca*.

21 *SWS Communication Inc. v. R.*, 2012 CarswellNat 945 (T.C.C. [General Procedure]). (Two appeals were heard on common evidence at the request of the parties.)

22 [Ed. Section 22.1 of Part V of Schedule VI to the ETA also requires that the supply be made by a registrant who carries on a business of supplying telecommunications services in order to be zero-rated, a condition which was not in issue in this case. In addition, the zero-rating provision excludes supplies of telecommunications services where the telecommunication is emitted and received in Canada. However, the Crown did not appear to rely on this exclusion in challenging the zero-rated status of the supplies in question.].